FISCAL POLICY

Its Techniques and Institutional Setting

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To MARY, DANIEL, and ANNE

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Preface

Fiscal policy is here taken to mean use of government expenditure and revenue as balancing factors to secure economic stabilization. In this sense it is definitely a *parvenu*. Twenty years ago, in 1933, Hugh Dalton, then an eminent student of public finance and later, as Chancellor of the Exchequer, an eminent practitioner, expressed judgments quite contrary to fiscal policy as now affirmed. Unbalanced budgets, so Dalton then thought, might cause inflation; higher taxation in depression to secure balanced budgets would not postpone recovery.[1] Such opinions are now held only by a few devotees of "sound" finance, and Dalton was never one of them. Most economists have come to believe that deficits in depression are therapeutic, while higher taxes are baneful. The shift in economic opinion is so complete as to be startling. The passage of the Employment Act of 1946 (and similar measures in other English-speaking and in Scandinavian countries) seems to indicate that legislatures, as well as economists, have become converts to fiscal policy.

Recently some doubts have emerged, especially in the United States. Congress, after World War II, did not perform as fiscal theory prescribed, and the actual pattern of events was very different from what economists had postulated. The Council of Economic Advisers not only failed to recommend actions consistent with the principles of fiscal policy, but even yielded to political blandishments. Enthusiasm for fiscal policy cooled off as the institutional and political setting came to be reappreciated.

In the pages which follow the effort is to provide a synthesis, on an elementary level, of the theory and practice of fiscal policy in the United States. Some knowledge of public finance is assumed, and the exposition is not meant to be "popular." Although

[1] *Unbalanced Budgets* (London, G. Routledge & Sons, Ltd., 1934).

no contribution to theory is attempted and no claim to originality is advanced, I cannot always trace my intellectual indebtedness. Considerable institutional material is presented because fiscal policy is concerned with what government shall and can do: it is a part of political economy.

I have left unmentioned many methods of countercyclical action, and some of my omissions will be regretted by some people. While my selection is partly a matter of personal choice, I have aimed to include those methods which seem to have appeal to the Congress and to be reconcilable with current Congressional techniques.

The names in my footnotes show, inadequately, my debt to many economists. In addition, I have received valuable suggestions from Eric J. Hanson, M. Slade Kendrick, Raymond E. Manning, Eugene E. Oakes, Joseph A. Pechman, Herbert Stein, Philip E. Taylor, and Haskell P. Wald. The Merrill Foundation for the Advancement of Financial Knowledge made a grant to Clark University, and the Social Science Research Council made a grant to me, which helped greatly in financing my study. I record here my gratitude to both organizations. Finally, I am indebted to Clark University for a sabbatical leave during the second semester of 1953.

J. A. M.

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Brief Survey of Theories of Government Functions

> [Government] is the most precious of human possessions; and no care can be too great to be spent on enabling it to do its work in the best way: a chief condition to that end is that it should not be set to work for which it is not specially qualified, under the conditions of time and place.—ALFRED MARSHALL.[1]

> Since the great depression the most widely discussed cure for unemployment has been fiscal policy. It has come to have much the same prominence as central bank policy had in the twenties. It has been the history of major ideas about monetary policy that there is a warming-up period followed by a cooling-off period, and we have yet to look at fiscal policy in adequate historical perspective.—JOHN H. WILLIAMS.[2]

1. HISTORICAL DEVELOPMENT OF THOUGHT CONCERNING THE AGENDA OF GOVERNMENT

Strong faith in government in ancient times

In the long history of economic doctrine a very wide range of opinion has been expressed concerning the beneficence or harmfulness of government activity. This diversity is a direct result of theories men have held concerning the appropriate sphere of

[1] Alfred Marshall, *Industry and Trade* (New York, The Macmillan Co., 1923), pp. 647-48.

[2] Paul T. Homan and Fritz Machlup (eds.), *Financing American Prosperity* (New York, Twentieth Century Fund, 1945), p. 345.

government. To the ancient philosophers no task was too great for government, and Plato explicitly declared that it should organize both economic and noneconomic activities so as to secure wisdom in the rulers, bravery in the soldiers, and temperance in the common people. For nearly 2,000 years this philosophical faith in government continued, coupled with a deemphasis of economic factors.

Mercantilism and economic action by government

A great change in emphasis came with that heterogeneous group of writers called the Mercantilists. They shared Plato's faith in the efficacy and desirability of governmental action, but they elevated, as he had not, the importance of *economic* action by government. Government should act so as to expand exports and diminish imports, to establish new industries, to reduce idleness, to encourage shipping, etc. Their premise, as that of Plato and the Schoolmen, was that individuals, pursuing their own economic gain, would usually act contrary to the public interest. But unlike Plato and the Schoolmen, they did not debate whether or not a nation (or an individual) *should* become wealthy. Assuming an affirmative answer, their concern was: How could a nation become wealthy? And the universal if inarticulate premise of their diverse schemes was that governmental intervention was essential. By that intervention—"by the dextrous management of a skillful Politician"—even private vices might "be turned into Public Benefits."[3] No class in the community should be left undirected, not even the merchant who is worthily called "the Steward of the Kingdom's Stock."[4] The very virtues of the merchant made it vital that he be subject to governmental oversight. Sir Thomas Gresham put the point neatly:

> As the merchants be one of the best members in the common weal, so they be the very worst if their doings be not looked into in time; and forced to keep good order.[5]

[3] Eli F. Heckscher, *Mercantilism* (London, G. Allen and Unwin, 1935), Vol. II, p. 293.

[4] Thomas Mun, *England's Treasure by Foreign Trade* (New York, The Macmillan Co., 1928), p. 1.

[5] Heckscher, *op. cit.*, II, p. 320.

Instruments of public finance to achieve economic ends

Much more explicitly than any previous writers the Mercantilists wished to use the instrumentality of public finance to achieve their ends.[6] Taxes should serve as a "bridle" to guide economic activity along paths which would bring well-being to the nation.[7] They were a means to accumulate a reserve of "treasure." According to Josiah Tucker, a good tax is one which tends

> to prevent idleness, check extravagance and promote industry. . . . That state or kingdom which by means of proper taxes converts drones into bees will be rich: But every community which turns bees into drones must be poor.[8]

Adam Smith and restriction of government functions

Every schoolboy knows that in opposition to the Mercantilists a school of thought grew up which wished to restrict the scope of governmental functions and therefore governmental expenditure and taxation. In Great Britain Adam Smith provided the most attractive exposition of this new opinion. For him government had "three duties of great importance, indeed, but plain and intelligible to common understandings"—(1) national defense, (2) maintenance of internal security, (3) establishment and maintenance of certain essential public institutions which private persons would always find unprofitable. In all other cases government should leave the individual "free to pursue his own interest in his own way, and to bring both his industry and his capital into competition with those of any man, or order of men."[9] In particular, the government should *not* attempt to direct the capital and labor of private people "toward the employments most suitable to the interest of the society." Government, if it attempted such a task, would always be "exposed to innumerable delusions."

[6] "Trade is the source of [public] finance and [public] finance is the vital nerve of war." *Ibid.*, quoting Colbert, II, p. 17.

[7] L. Cossa, *Introduction to the Study of Political Economy* (London, Macmillan & Co., Ltd., 1892), quoting Justi, p. 237.

[8] Josiah Tucker, *A Selection from His Economic and Political Writings* (New York, Columbia University Press, 1931), p. 14.

[9] Adam Smith, *The Wealth of Nations* (New York, E. P. Dutton and Co., 1910), Vol. II, p. 180. (Everymans)

This philosophy was elaborated by Smith's successors, as well as by practical statesmen, and in the process the acceptable functions of government were narrowed much beyond what Smith would have approved. J. B. Say declared that "the very best of all plans of finance is to spend little, and the best of all taxes is that which is least in amount."[10] Sir Henry Parnell declared that

> every particle of expense that is incurred beyond what necessity absolutely requires for the preservation of social order and for protection against foreign attack is waste, and an unjust and oppressive imposition upon the public.[11]

And Gladstone, perhaps the most eminent practitioner of public finance of the nineteenth century, spoke of the desirability of leaving money to fructify in the pockets of the people instead of being taken by taxation to be employed unproductively or even wastefully.

Development of a strong civil service

The practitioners of laissez faire, by limiting the functions of government, by building up an efficient civil service to do a limited job, and by testing fiscal instruments of great flexibility, inadvertently laid foundations which made possible a vast extension of governmental activity.[12] When World War I (and still more World War II) forced the pace, government undertook to perform economic tasks so difficult that the boldest Mercantilist

[10] Quoted as a "golden maxim" by David Ricardo, *Principles of Political Economy* (New York, E. P. Dutton and Co., 1912), p. 154.

[11] Quoted by T. Findlay Shirras, *The Science of Public Finance* (London, Macmillan & Co., Ltd., 1925), p. 37. The extreme laissez-faire position raised public shiftlessness to the dignity of a philosophy of government, and it was given a contemporary answer by men who today would be regarded as conservatives. The trenchant words of Thomas Henry Huxley provide one example. He declared: "If my next door neighbor chooses to have his drains in such a state as to create a poisonous atmosphere, which I breathe at the risk of typhus and diphtheria, he restricts my just freedom to live just as much as if he went about with a pistol, threatening my life; if he is to be allowed to let his children go unvaccinated, he might as well be allowed to leave strychnine lozenges about in the way of mine; and if he brings them up untaught and untrained to earn their living, he is doing his best to restrict my freedom, by increasing the burden of taxation for the support of gaols and workhouses, which I have to pay." *Ibid.*, pp. 37-38.

[12] Heckscher, *op. cit.*, II, pp. 324-26.

might have flinched. Some of these tasks—rationing, price and wage control, allocations--are inconsistent with peacetime maintenance of a system of free enterprise. But the point is that government has now, as it had not in the seventeenth century, the technical means and the economic knowledge to carry through a wide range of functions. A socialist system is no longer merely a blueprint; it is a going concern in several countries. The feasible agenda of government is not now limited narrowly by administrative considerations, as it was when Adam Smith wrote in 1776.

2. WHAT NOW SHOULD BE THE AGENDA OF GOVERNMENT?

What, then, today should be the agenda of government, and particularly, what should be its fiscal program? Admitting that government may be able by taxes to take some money from the pockets of the people and spend it more advantageously than private persons, what limit should be set to the process? For what services has government a relative advantage over private enterprise?

Collective vs. noncollective services

A distinction can be drawn between services which render collective benefits and those which do not. Collective services are rendered to citizens as a whole, rather than to individual citizens. Defense is the clearest example, and decisions concerning its provision must be governmental. A wide range of other services—education, welfare, construction of highways—are largely collective, although particular benefits are rendered cutting across the collective benefits. The justification for governmental, rather than private, action is always that a large element of collective benefit inheres in the services. Where it does not, services can be rendered privately by citizens to other citizens. Inevitably, of course, the division between the public and the private sphere is a penumbra within which the actual line of demarcation will shift because of shifts in public opinion concerning the admixture of collective and particular benefits in certain services.

Contrast between private and public economy

Resource allocation by the market in private economy

In bold outline the contrast between the private and the public economy is clear. In the former, individual citizens as consumers in possession of dollars try to maximize their satisfactions and as producers try to maximize their net incomes. Labor and capital are allocated in response to these dollar demands. In the private economy individual citizens buy goods and services from private businesses (and also sell to private businesses) taking as much or as little as they choose. The price paid is uniform for each buyer and seller, and must in the long term cover the firm's cost of production. The balancing of satisfaction received and given is a matter for individual decision.

Resource allocation by compulsion in public economy

In the public economy provision of collective services and allocation of costs is through compulsion. An individual is not allowed to specify the amount of defense he will take or the price he will voluntarily pay for it. Not only is the decision concerning the proper amount of defense collective, but the government distributes the cost among citizens through taxes; that is, through compulsory payments assessed by general rules rather than by prices which are voluntary payments not assessed at all.

These characteristics outline in the broadest terms the boundary between the public and the private economy. The crucial debate arises when the boundary is made precise. For instance, does the collective interest in economic security justify governmental provision of health insurance? What is the collective interest in provision of the supply of electrical energy?

Political basis for allocation in public sphere

The basis upon which decisions are taken to allocate resources of labor and capital to the public sphere is political. In a country like the United States, citizens—the majority of them—are responsible for the amount and the direction of governmental expenditure. The process is indirect and haphazard, since it operates through a system of representative government, and is in contrast

with the process by which decisions concerning the allocation of resources operate in the private economy. Over the long run the limit of expenditure for an individual is set by his current income; unless he can earn more, he cannot spend more. But because government has the power of compulsion, it is limited in its spending only by its ability to raise money from all the citizens. With respect to the direction of expenditure, the individual citizen tries to use his dollars so that the satisfaction secured by him from each of them is equal. This feat is performed with indifferent success by most of us, even after long experience. But the decisions of government concerning the direction of its expenditure—whether it shall expand or contract present expenditures or begin new expenditures—rest on the precarious basis of a collective judgment. The people as citizens must decide upon the appropriate allocation of resources between the public and private spheres, and within the public sphere.

The responsibility of Congress

The immediate responsibility for collective decisions concerning governmental expenditures rests upon Congress. By voting appropriations it decides both the amount and the direction of public expenditure. And since most of these will be financed by taxation, Congress has the related task of deciding how and in what amount resources will be taken out of the pockets of citizens and put into the public purse. Congress will, of course, not have to re-examine yearly every detail of the budget, since it will assume that the broad pattern set by the past is a present guide. But a limit must be determined for expenditures as a whole and for each avenue of expenditure. Congress will attempt to make its decisions with the opinions of the majority of the citizens in mind, and these opinions are not constant over time. What one generation of voters rejects, another will embrace, sometimes because of changed conditions and sometimes because of a shift in social philosophy.

Socialist vs. free-enterprise economies

In the exposition above a distinction was drawn between the collective and the noncollective functions of government and this distinction offers a nebulous boundary between a free-enterprise

and a socialist economy. In the latter government would not only provide collective services, but also would own and operate the major industries which supply particular services to citizens. In the former private enterprise operating on the basis of profit-seeking would provide many particular services for citizens. The exposition of this book is applicable only to a free-enterprise system of which the United States is now the chief exemplar. Government in the United States operates some commercial enterprises, but in almost every case a strong collective interest is believed to exist. No debate goes on here, as it does in Great Britain, over nationalization of steel, or transport, or coal.

A great economist, Lord Keynes, who was not a socialist and yet was not inhibited by "capitalist" conventions, has offered a realistic test for the agenda of government in a free-enterprise economy. It is that government should not attempt to do any job which is being done, or can be done, reasonably well by private enterprise. What government should handle are those tasks which, unless done by it, will not be done at all.[13] It will be argued in subsequent pages that prominent among them stands the function of fiscal policy; i.e., *the use of government expenditure and revenue as balancing factors to secure economic stabilization.*

Political agreement on government agenda necessary for successful fiscal policy

Fiscal policy is, however, most likely to succeed in nations where the major political parties do not disagree chiefly about the agenda of government; in this respect, conditions in the

[13] J. M. Keynes, *Essays in Persuasion* (New York, Harcourt, Brace & Co., 1932), pp. 313, 316, 317. He wrote: "Perhaps the chief task of Economists at this hour is to distinguish afresh the *Agenda* of Government from the *Non-Agenda*; and the companion task of Politics is to devise forms of Government within a Democracy which shall be capable of accomplishing the *Agenda*. . . .

"I criticize doctrinaire State Socialism . . . because it is, in fact, little better than a dusty survival of a plan to meet the problems of fifty years ago, based on a misunderstanding of what some one said a hundred years ago. . . .

"The most important *Agenda* of the State relate not to those activities which private individuals are already fulfilling, but to those functions which fall outside the sphere of the individual, to those decisions which are made by *no one* if the State does not make them. The important thing for Government is not to do things which individuals are doing already, but to do those things which at present are not done at all."

United States are unusually favorable. On the other hand, in countries where a deep cleavage over agenda prevails, fiscal policy, which in the nature of the case aims to secure results in the fairly short run, seems likely to fail to counteract both boom and depression. If in time of high employment the party *left* of center is in office, action by it to extend the sphere of government will bring inflation; in time of depression pursuit of its program may be expected to have adverse effects on private spending. But if in time of prosperity the party *right* of center is in office, action to shrink the agenda of government will be challenged by the opposition. Private investors will, therefore, look upon this governmental action as insecure and reversible. In depression action by the conservative party will be blocked by fear of increasing unemployment.

3. THE ASSUMPTIONS OF CLASSICAL PUBLIC FINANCE MADE FISCAL POLICY UNNECESSARY

Full employment

The classical literature of public finance assumed a noncyclical society with full employment of labor and capital; it did not formulate taxing and spending policies with an eye to their countercyclical effect. This did not, indeed, imply that public expenditure had no effects on the economy. Governmental demand was a part of the total demand for goods and services. As such it affected (a) the form and type of goods produced, (b) the conditions of employment, (c) the public taste. What the older writers denied was that public expenditure increased the *total* of employment. C. F. Bastable treated the theory that government expenditure gave employment as a "gross fallacy"[14] which overlooked the fact that the revenue taken from private hands to cover the expenditure would certainly have been em-

[14] C. F. Bastable, *Public Finance* (London, Macmillan & Co., Ltd., 1922), p. 145, 283. H. L. Lutz, *Public Finance* (New York, D. Appleton and Co., 1925, p. 105), writes that "expenditure of this revenue is a diversion of a certain volume of purchasing power from the control of the citizens to the control of the state." And M. H. Hunter, *Outlines of Public Finance* (New York, Harper & Brothers, 1926, p. 34), writes: "The more a state takes from individuals and spends, out of a given amount, the less is left for individual expenditure."

ployed to hire labor or to purchase commodities. Given the premises, the conclusion followed, but the point of relevance is his neglect of cyclical variation. If what was taken in taxes would *not* otherwise have been spent, and if unemployed resources of labor and capital were at hand, then government taxing and spending would add to the total demand. And suppose the government spending were financed not out of taxes, but by creation of new purchasing power? This possibility was not envisaged.

While this error of omission was attributable mainly to the assumption of full employment, its discovery was delayed because of the small impact which government finance made on the economy. Before World War I government expenditure in the United States was 6½ percent of national income; during the 1920's it was less than 10 percent.

Effect of depression in the 1930's on classical assumption

Then after 1929 came a depression which in amplitude and duration was without precedent in modern times. Faith in the self-adjusting power of the economy wore thin, and, even before the New Deal, Congress tried to give relief to farmers, business, the unemployed. No coherent program for recovery was framed, and, in the opinion of one competent observer, what was done before 1937 would have been done "without a line written by economists on deficit spending."[15] But, meanwhile, *The General Theory,* emanating from the depression, gave a logical core to fiscal policy.[16]

Stress by fiscal policy on effect of taxes and spending on the economy as a whole

In the theory of traditional public finance the government used expenditures and taxes to secure particular objectives such as construction of a highway or provision of compulsory educa-

[15] Gerhard Colm in Seymour E. Harris (ed.), *The New Economics* (New York, Alfred A. Knopf, 1927), p. 451. Roy Blough states that, up to 1937, Mr. Roosevelt believed in a balanced budget. *The Federal Taxing Process* (New York, The Macmillan Co., 1952), pp. 241-42.

[16] Roy F. Harrod, *The Life of John Maynard Keynes* (New York, Harcourt, Brace & Co., 1950), p. 472.

tion for the youth. Their direct effect upon the economy *as a whole* received little or no appraisal.[17] Fiscal policy, by way of contrast, emphasizes the effects of government expenditure and revenue upon the total economy and argues that they should be used deliberately and consciously as "a balancing factor" to secure economic stabilization.[18] Fiscal policy is, therefore, *not* concerned with particular types of spending to secure limited objectives, or with particular taxes; it is *not* concerned with budgetary administration or debt management in so far as they are techniques for orderly government housekeeping.

4. MERITS AND DIFFICULTIES OF THIS DEFINITION OF FISCAL POLICY

Merit of a narrow definition of fiscal policy

The narrowness of the above definition should be appreciated. By it, fiscal policy is restricted to conscious use of government finance to affect countercyclically the *total* money demand for goods and services. This implies that haphazard and nondeliberate use is *not* fiscal policy; yet everyone knows that whatever government is doing via spending, taxing, and borrowing may affect the level of employment and income. "Given financial policies result in certain economic effects, irrespective of the reason for their adoption."[19] But the merit of the narrow defi-

[17] Assuming full employment, an addition to government spending would bring inflation, and this possibility did not escape the classical writers. What they failed to appraise was the effect of adding to aggregate demand in depression.

[18] J. M. Keynes, *General Theory of Employment, Interest and Money* (New York, Harcourt, Brace & Co., 1936), p. 220. As will later be made clear, the aim is not to stabilize at a level, but to *set limits* to instability.

[19] Kenyon Poole (ed.), *Fiscal Policies and the American Economy* (New York, Prentice-Hall, 1951), p. 2. Examination of current texts discloses no consistent usage. M. Slade Kendrick, however, defines fiscal policy as the use of public finance "as an instrument to regulate the functioning of the economy." *Public Finance* (Boston, Houghton Mifflin, 1951), p. 675. Philip E. Taylor, while sometimes using the terms "public finance" and "fiscal policy" as synonomous, separates out the "compensatory" use of public finance. *The Economics of Public Finance,* rev. ed. (New York, The Macmillan Co., 1953), p. 510. Harold M. Groves states that fiscal policy "concerns itself with financial problems pertaining to the full and effective use of resources." *Financing Government,* 4th ed., (New York, Henry Holt and Co., 1954), p. 499. All of the above are consistent with the definition given by me.

nition grows out of its limitations. Policy implies a conscious effort. If Congress in its financial actions remains unconscious of *over-all* effects, then fiscal policy will not operate except by accident. The level of employment and income will in fact be lifted or lowered by Congressional programs, but stabilization of the level will not be achieved. Indeed, the likelihood is that the over-all variation will be increased with injury to the economy. Congress must recognize that reduction of taxes or distribution of a veteran's bonus when employment is high will create a boom; that increase of taxes and reduced spending for public works when employment is low will create depression. If such recognition is absent, fiscal policy will not exist; its theoretical promise as a countercyclical device will not be realized.

Retrospective appraisal of the 1920's and 1930's

A retrospective survey of federal tax and expenditure programs in the 1920's and 1930's will indicate the political motivations and the older economic theories which fiscal policy, as now conceived, must face. Tax reductions were made in 1921, 1924, 1926, 1928 and 1929. Three of these—1921, 1924, 1929—probably operated countercyclically, but the motivation was *not* countercyclical. In 1921 a new administration had taken office, the level of taxes was higher than ever before in our peacetime history, a small surplus had been achieved in fiscal 1920 and a large one in fiscal 1921. These facts, and especially the last one, give the explanation for the tax reduction of 1921. In the fiscal years 1922, 1923, and 1924 surpluses continued—that in 1924 was 12 percent in excess of expenditures. Moreover, in 1924 a presidential election was due. These facts explain the reduction of 1924. The reduction of December 1929 did stem from embryo considerations of fiscal policy. Made in December by Joint Resolution, the cut came after the stock market break of October and was meant to stimulate recovery. But the reduction (1 percent in normal tax and corporation tax) was only for the calendar year 1929, and the Ways and Means Committee specifically declared that it intended simply to pass on to taxpayers the surplus achieved in fiscal 1929.[20]

[20] 71st Congress, 2d Sess., House *Report* 24, p. 2. The minority report, in opposition to the action, declared that debt reduction was more important than tax reduction.

The tax reductions of 1926 and 1928—years of prosperity—were obviously not motivated by countercyclical considerations. They were expressions of the philosophy of the Secretary of the Treasury, Andrew Mellon, that high taxes, especially high surtaxes, impaired capital accumulation and business incentive.

Faulty assumption of effect of deficits on government credit responsible for erroneous policies of 1932

What was done in 1932-1933 was, of course, quite contradictory to fiscal policy. In 1932 Congress increased the levies on individual and corporate incomes, and it came very close to enacting a sales tax; by the Economy Act of 1933 it reduced salaries of civil servants and many departmental appropriations.[21] The principle that lay behind these steps, which now appear altogether erroneous, was that an unbalanced federal budget impaired the national credit and undermined business confidence.[22]

The fault here is not so much in the conclusion as in the premises. When the currency and the credit of the national government are in danger, then deficits *are* ruinous. The error was in assuming the credit standing of the government to be more delicate than it was in fact. But that deficits can be ruinous when otherwise a nation is economically sound is shown by the recent history of many European countries where an unstable currency, weak government credit, and budgetary unbalance interact to debar fiscal policy.

[21] The Revenue Act of 1932 lowered the personal exemptions from $3,500 to $2,500 for a married couple and from $1,500 to $1,000 for single persons; eliminated the earned income credit; increased normal rates from 4 percent to 8 percent and surtax rates from a maximum of 20 percent to 55 percent. The corporation income tax rate was raised from 12 percent to 13¾ percent. The rates of the estate tax were also lifted. A considerable number of excises were imposed, among them a gasoline tax of one cent per gallon. With respect to expenditures decreases were, in the aggregate, more than offset by increases in relief functions.

[22] The Democratic platform of 1932 declared for "maintenance of the national credit by a Federal budget annually balanced." Senator Carter Glass, perhaps the most influential spokesman of the party on financial questions during the presidential campaign of 1932, attacked the Hoover administration for an unbalanced budget. In the middle of 1932 President Hoover said (*Congressional Record*, Vol. 75, p. 10959): "It is generally agreed that the balancing of the Federal Budget and unimpaired national credit is indispensable to the restoration of confidence and to the very start of economic recovery. . . .

"A public works program . . . through the issuance of Federal bonds, creates at once an enormous further deficit."

Extreme positions *contra* and *pro* fiscal policy

The opinion of professional economists is at present strongly favorable to the proposition that economic stabilization through fiscal policy is one of the important functions of government. Dissent comes from two directions. At one pole is the view that the only valid purpose of taxes is to raise money to meet government costs.[23] At the other pole is the theory of functional finance which elevates fiscal policy to a paramount role. "Taxes should *never* be imposed for the sake of the tax revenues"; spending should be for particular purposes, but in depression even "harmful" spending "may be better than doing nothing to increase employment."[24]

The error of this second view is in its emphasis. The weight of most fiscal policy actions is not known and may never be precisely known in a free-enterprise economy. In time of depression Congress can reckon in general terms the effect on employment from reduced revenues and increased spending, but if employment does not grow as reckoned, Congress must not be committed to pursuit *à outrance*. Moreover, our present administrative and political machinery cannot make technical fiscal decisions precisely effective; modification of this machinery is needed to effectuate even a modest fiscal policy. But modification is not the same as revolution, and functional finance would require revolutionary administrative and political changes.

Proponents of both views would (or should) reject nonfiscal use of taxation—regulatory levies on firearms, narcotics, state bank notes. Yet surely these taxes have some merit in achieving nonfiscal ends.

Taxes should, moreover, be framed somewhat with long-run social and economic objectives in mind, and not merely with the short-run objective of economic stabilization. In boom and depression, considerations of tax equity may, for the time, be set aside, but they should not be scrapped.

[23] This position is taken, for example, by F. R. Fairchild. See *Bulletin of the National Tax Association* (October 1944), p. 2.

[24] A. P. Lerner, *Economics of Employment* (New York, McGraw-Hill Book Co., 1951), p. 131; *Economics of Control* (New York, The Macmillan Co., 1949), p. 317.

2

Stabilization Devices Other Than Fiscal Policy

> The right principle is to respect all the principles, take them fully into account, and then use good judgment as to how far to follow one or the other in the case in hand. . . . There is always a principle, plausible and even sound within limits, to justify any possible course of action and, of course, the opposite one. The truly right course is a matter of the best compromise, or the best or "least-worst" combination of good and evil.—FRANK H. KNIGHT.[1]

Fiscal policy is one of a quartet of devices used to control the economic system, and while this study will expound only fiscal policy, a brief discussion of the relevance of the other three—monetary policy, debt management, and direct controls—is offered with the aim of showing their relationship to fiscal policy. Monetary policy, as will appear, is a natural and inevitable complement to fiscal policy, since the most effective use of the one depends upon appropriate use of the other. Debt management is a newcomer about which little has been written and of which, at present, not much can be expected. Direct controls are, in the short run, by far the most powerful of the quartet; under wartime conditions in a democratic nation, and in an authoritarian nation at all times, their dominance is unavoidable. But since in these pages peaceful conditions and democratic government are assumed, the few paragraphs about direct controls aim simply to state why they are inappropriate.

[1] F. H. Knight, "Principles in Economics and Politics," *American Economic Review* (March 1951), p. 6.

1. MONETARY POLICY

In the 1920's most economists had a strong faith in the efficacy of monetary policy. The Federal Reserve by use of open-market operations and rediscount rates would, they thought, be able to stabilize the price level. Implicitly the assumption was that, if this were achieved, the economy would stay on an even keel and unemployment would be modest in amount. The Congress, in creating the Federal Reserve, had not specified this objective, and, in the 1920's, the officers of the system resisted successfully several friendly Congressional efforts to provide an explicit objective. But this resistance stemmed chiefly from a fear that their hands might be tied, and not from objection to stabilization of the price level as a major goal of central bank policy.

Monetary policy in disrepute after 1929

Faith in monetary policy was nearly destroyed in the 1930's when its techniques, for whatever reason, seemed ineffective first in halting depression and next in restoring recovery. For these failures many excuses have been offered: some economists declare that the Federal Reserve failed to use the powers which it had with force and vigor, others state that the fault lay with the inadequacy of its powers and defects of internal organization. The excuses are plausible rather than convincing. Despite reorganization of the Federal Reserve in 1935 so as to increase the powers of the Board of Governors, monetary policy fell into disrepute. In its place fiscal measures were utilized, not at first systematically or in accord with a consistent theory, but as practical steps to provide employment and relief. Monetary policy was submerged by fiscal policy.

Subordinate position during World War II and postwar

With World War II all thought of an independent monetary policy was put aside, and the Federal Reserve agreed in March 1942 to maintain for the duration of the war the existing level and pattern of interest rates on federal securities. In effect, monetary policy became subservient to Treasury borrowing and debt management.

Postwar this program was modified only slightly. Early in 1946 the Federal Reserve, despite protest from the Secretary of the Treasury (Mr. Fred Vinson), did eliminate the preferential discount rate of ½ percent for loans to member banks on short-term securities; in mid-1947 it ended the pegging of short-term Treasury bills. But with respect to long-term bonds the policy of support so as to maintain a yield of 2½ percent was continued, and even for short-term and intermediate issues the increases in yield were narrowly limited.

What reasons lay behind this postwar continuance of a policy of low and relatively rigid interest rates on federal securities? They were twofold: (1) It held down interest charges on the vast federal debt and simplified the Treasury job of refunding and conversion. (2) It meant low interest rates for private as well as public borrowing, and this was declared by some to be a prime prerequisite for economic progress. As supplementary reasons proponents argued negatively that variable prices for government bonds might impair confidence in the government credit and bring losses to holders, and that a rise in interest rates—a restrictive monetary policy—would anyway be ineffective in checking inflation.[2]

Whatever a restrictive monetary policy might have done, 1945-1949, the actual policy made it impossible. The commercial banks were out of debt to the Federal Reserve, and they had large holdings of federal bonds. So long as the Federal Reserve was committed to purchase at a fixed price whatever amount of federal securities the commercial banks cared to offer, it was nearly powerless to diminish their reserves. Two of its three chief instruments for restriction of credit—open-market operations and

[2] In answering questions put by the Douglas Subcommittee Mr. Snyder stated: "I do not agree with those who believe that if the support prices of Government securities had been lowered below par, sales of these securities to the Federal Reserve would have been stopped and inflationary pressures would have been lessened. It seemed to me that, under the circumstances which existed, we would have taken the risk of impairing confidence in the Government's credit if the prices of Government bonds had been permitted to go below par; and that as a result the Federal Reserve might have had to purchase more bonds below par than at a par-support level. This, of course, would have increased bank reserves and to that extent would have been inflationary rather than anti-inflationary." 81st Congress, 1st Sess., Joint Committee on the Economic Report, Subcommittee on Monetary, Credit and Fiscal Policies, *A Collection of Statements*, p. 10.

increase of rediscount rates—were blunted, and the third, increase in reserve requirements of member banks, had been used up. Inflation went forward unchecked by a restrictive monetary policy.[3]

The Douglas Subcommittee

In the spring of 1951 the Federal Reserve recovered some of its power over monetary policy, and at present great expectations of its efficacy are once again cherished. The turn in events owes much to the intervention of a Congressional committee. In mid-1949 the so-called Douglas Subcommittee (of the Joint Committee on the Economic Report) on Monetary, Credit and Fiscal Policies was appointed. Its report in January 1950 emphasized that fiscal policy could and should be supplemented by a vigorous monetary policy. In particular, the report declared "that the freedom of the Federal Reserve to restrict credit and raise interest rates for general stabilization purposes should be restored even if the cost should prove to be a significant increase in service charges on the Federal debt and a greater inconvenience to the Treasury in its sale of securities for new financing and refunding purposes."[4]

Before five months had passed a political event—war in Korea—gave these questions a sharper focus. Between June 1950 and the end of the year wholesale prices rose by 14 percent, and prices of import commodities by 50 percent. The Federal Reserve could properly argue that inflation was the danger and that monetary policy should be utilized as a restraint. The Treasury, on the other hand, argued that a third world war might be imminent. Nothing should be done, therefore, to raise money rates or to upset the money market, since very large federal borrowings might soon be necessary. The public became aware of the conflict of objectives when, on August 18, 1950, the Federal Reserve Open-Market Committee announced its determination to combat inflation with all its power, while the Treasury on the same day announced a $13 billion issue of short-term securities at current rates. While the Federal Reserve prevented the issue from failing,

[3] In the recession of 1949 credit restriction was, of course, inappropriate. The Federal Reserve took expansionary steps by reducing margin requirements, easing consumer credit, and reducing reserve requirements for member banks.

[4] 81st Congress, 2d Sess., Senate Document No. 129, p. 2.

it proceeded to raise short-term rates of interest and the Treasury acquiesced.

The accord of March 1951

Early in 1951 Mr. Snyder, the Secretary of the Treasury, with the support of President Truman attempted publicly to recommit the Federal Reserve to maintenance of a 2½-percent interest rate on long-term bonds. Again the Federal Reserve rebelled, and, after several weeks of controversy, an "accord" was reached on March 3. Subject to a commitment to maintain an "orderly" market for government bonds, the Federal Reserve gained freedom to raise market rates of interest, to allow government securities to fall in price and, therefore, to impose capital losses on sellers. A restrictive monetary policy became feasible.

Meanwhile, in the spring of 1951 another subcommittee of the Joint Committee—the so-called Patman Subcommittee—was appointed, which conducted an elaborate study on Monetary Policy and the Management of Public Debt. Its report in June 1952 reaffirmed the recommendations of the Douglas Subcommittee that a flexible fiscal policy should be "a principal reliance of the Federal Government in promoting price stability and high-level employment," that monetary policy should be an essential supplement, and that the independence of the Federal Reserve "*within* and not *from* the Government" was a means to this end.[5]

Flexibility, especially to counteract inflation, a merit of monetary policy

If monetary and fiscal policy can be used as a team in an attempt to gain economic stability, each will be found to have merits and demerits. The special merit of monetary policy is its relative flexibility. Whereas the mechanism for implementing fiscal policy is hampered by traditional legislative and executive procedures, that for monetary policy is completely outside the ordinary processes of government. Use by the Board of Governors of the Federal Reserve of the instruments of credit control does not depend upon clearance by the Congress or the Executive.

[5] 82d Congress, 2d Sess., Joint Committee on the Economic Report, Report of the Subcommittee on General Credit Control and Debt Management, *Monetary Policy and the Management of the Public Debt*, pp. 2, 4.

This flexibility of monetary policy is of special merit as an anti-inflationary device. In a period of inflation use of fiscal instruments—higher taxes and less spending—encounters, and will continue to encounter, public and Congressional resistance. Rising prices do not naturally condition citizens to higher tax rates, or Congress to passage of smaller appropriations. In short, the very directness of impact of a restrictive fiscal policy inhibits its use. But restrictive use of the instruments of monetary policy is semi-anonymous in the sense that most citizens will be unaware of their employment; it operates upon the supply of money rather than, as do taxes, upon the incomes of individuals.[6]

The experience outlined above indicates, however, that exercise of monetary policy to restrain inflation may be impeded when the federal debt is very large and when the interest charges on this debt are so low that they can hardly be lower. The Treasury, and perhaps the Congress, may be tempted to resist increases in interest rates no matter what the stage of the cycle. Open-market sale of federal securities (nowadays the vehicle of open-market operations) may, therefore, be hindered and so also will increase of rediscount rates. Monetary policy as a device to counteract inflation presupposes that this sort of conflict will not occur. The monetary authority must be able to restrict the availability of credit by reducing the reserves of commercial banks. Sale of securities by the Federal Reserve lowers their price and increases their yield, with a double effect on the commercial banks—and on other holders of federal securities. First, to some degree they will be "pinned in" because they will not want to take a capital loss. Second, they will be somewhat persuaded to hold the securities by the increase in yield.

Experience since the "accord" has resuscitated monetary policy. In 1951-1953 inflationary pressures abated, and *some* credit is due to action by the Federal Reserve. Yields of federal securities rose

[6] The National Planning Association in October 1951 sponsored a conference of twenty-one university economists who framed a statement "Monetary Policy to Combat Inflation." Seventeen of the group signed the statement, although there were fourteen dissents or qualifications; and four would not sign. Some dissenters thought the statement exaggerated the power of monetary policy, while others took the opposite view. 82d Congress, 2d Sess., Subcommittee on General Credit Control and Debt Management, *Monetary Policy and the Management of the Public Debt, Replies to Questions*, Part 2, pp. 1297-1302.

markedly, and the price of outstanding long-term federal bonds fell well below par without the adverse repercussions which had been forecast by the Treasury during the years when it insisted on a 2½-percent rate. But too much should not be claimed for monetary policy and for the Federal Reserve. Other forces were also anti-inflationary, most obviously that the pressure of business and consumer buying in anticipation of shortages subsided. Moreover, the Federal Reserve remains committed to maintenance of "orderly" conditions in the market for federal securities; if control of inflation required a drastic fall in price of federal securities, then presumably anti-inflationary monetary policy would give way.

It may be also that an even more fundamental difficulty has been overlaid, rather than solved. Although the Federal Reserve has regained power over *old* issues, it has only an advisory position with respect to *new* issues. Decisions concerning them are regarded as debt management, which traditionally belongs to the Treasury. Yet, obviously problems of monetary policy and of debt management overlap and *may* collide. In 1949-1951 the proposal was advanced that a national monetary and credit council be established on which both the Federal Reserve and the Treasury would be represented. At first the Federal Reserve was sympathetic, and the Treasury apathetic, toward this scheme; but by 1951 the two agencies switched positions. Support of the council was, so it seems, a symptom of weakness. This vacillation affected the Patman Subcommittee which merely recommended establishment of "a consultative and advisory council . . . on an experimental basis by executive order."[7] There the matter rests.

Monetary policy weak against recessionary forces

As a device to promote recovery from recession, monetary policy is weak. In the 1930's a great increase in bank reserves and the supply of money had little stimulative effect on business activity. Abundant bank reserves and low interest rates did not induce business to borrow and produce when it did not foresee how more goods could be marketed. An expansive fiscal policy, however, might well be successful in depression since its effect is on disposable incomes and not simply on the supply of money.

[7] *Ibid., Report* of the Subcommittee, pp. 5, 56-59.

Moreover, Congress and the public can understand, or at least be sympathetic toward, an expansive fiscal policy in depression.

Coordination of fiscal and monetary policy

Although the strength of monetary policy may be found in boom and of fiscal policy in recession, in both instances the one should be coordinated with the other. A deficit in depression unaccompanied by monetary expansion would keep interest rates higher, and reserve balances smaller, than they would be if the deficit were financed out of an additional supply of money. A surplus in boom unaccompanied by monetary contraction would be less restrictive than if the surplus were accompanied by a decreased supply of money.

2. DEBT MANAGEMENT

A device for economic stabilization

Besides fiscal policy and monetary policy, federal debt management may serve as a complementary tool for economic stabilization. Debt management has emerged postwar as a separate device because of (a) the vast growth in the size of the federal debt (gross debt was $40.4 billion on June 30, 1939, and $266.1 billion on June 30, 1953), and (b) its wide distribution among individuals and financial institutions. The growth in size meant that the problems of debt management became not merely those of 1939 multiplied by six;[8] they became different in *kind*. In the field of monetary policy, as has been explained, the vast debt raised more acutely than ever before the issue of the respective rsponsibilities of the Federal Reserve and the Treasury. The size and wide distribution of the debt meant that the *potential* power of monetary policy was magnified, but also that the Federal Reserve became more timid in use of this power and the Treasury more insistent on "cheap money." The prerogative of the Treasury to manage the debt and the prerogative of the Federal Reserve to operate monetary policy became interwoven. Half the assets of banks and insurance companies were in the form of federal securities. Deci-

[8] Charles C. Abbott, *The Federal Debt, Structure and Impact* (New York, Twentieth Century Fund, 1953), p. 187.

sions concerning maturity, eligibility for purchase, interest rates, affected over-all economic conditions.

The simplest and most natural assumption is that decrease in debt is achieved through a surplus, and increase through a deficit. Yet reflection will indicate that decrease and increase might come in other ways. The Treasury might secure funds and use them for debt reduction by letting its cash balances run down or by issuing new money. In such case the debt reduction might have an *inflationary* effect, whereas ordinary debt reduction brought about by use of a surplus of receipts over expenditures is deflationary. Conversely, the Treasury might increase debt in order to add to its cash balances or to retire Treasury currency. In such case, the debt increase might have a *deflationary* effect, whereas ordinary debt increase which results from a deficit is inflationary. In short, the effects of debt increase or decrease depend upon the *source of the funds.* The fact is, however, that the alternatives mentioned above are not of much importance. The officers who are responsible for debt management have only slight control over the source of funds; Congress, via its spending and taxing programs, has the important discretion.

The effects of debt increase and decrease depend also upon the *recipients* of the funds or of the new debt. If, in the case of debt reduction, the funds are paid to the Federal Reserve Banks the effect will be deflationary, but if paid to individuals, they may be inflationary. If, in the case of debt increase, the debt is sold to the investing public, the effect will be deflationary, while if sold to the commercial banks it may be inflationary. It should be obvious that those responsible for debt management have considerable freedom in these matters. They can choose which debt shall be retired and to whom new debt shall be issued. And similarly they have freedom in choosing the type of debt instrument.

Major aspects of debt management

Let it be assumed, therefore, that debt management has two major aspects:[9] (1) What should be the *maturity structure* of the

[9] The debt could be, and to some extent is, managed in many details which are neglected here. Conditions of convertibility into cash and into

federal debt? What should be its relative distribution among short-term, intermediate, and long-term issues? (2) How could debt management be used to reinforce a fiscal policy which achieved a deficit or surplus?

Short-term debt, the instrument for a deficit

Consider first debt management to supplement a deficit. Since the balance of the Treasury in the General Fund will seldom be large enough to absorb more than a modest deficit, a deficit ordinarily will require new financing. If the deficit occurs in recession, as correct fiscal policy would enjoin, it would be given most reinforcement by creation of new money through borrowing from the Federal Reserve, or borrowing from the commercial banks with Federal Reserve purchase of securities in the open market equal to the borrowing. The new securities should be short-term because they are near-money. So far as possible the financing of the deficit should *not* absorb funds which otherwise would have been used for consumption or investment. Private expenditure should not decline as a result of the increase in government expenditures; rather should it rise so as to be a supplement.

Long-term instruments and a surplus

The effect of a surplus, on the other hand, supposing it to be achieved in a period of boom, can best be reinforced by accumulating a larger balance in the General Fund, by retiring short-term debt held by the Federal Reserve Banks, or by refunding short-term into longer-term maturities. A surplus should, in short, be used so as not to enlarge commercial bank reserves or the supply of money in the hands of the public.

Short-term securities and shifts in maturity structure

The maturity structure of the federal debt—the other faucet of debt management—can be altered regardless of surpluses and

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other forms of debt, conditions of redemption, conditions restricting the types of holders and the amounts to be held—a vast thicket of conditions for purchase, sale, and redemption could be constructed with results which cannot be forecast. It may be surmised, however, that multiplication of conditions and creation of special types of securities would create so many annoyances as not to be worth while to the Treasury.

deficits. For countercyclical purposes maturities should be lengthened in periods of boom so as to reduce the liquidity of holders and shortened in periods of recession in order to increase liquidity. The flexibility which is feasible here should not be exaggerated. Even if Treasury devotion to countercycle debt management were secured, freedom to shift the center of gravity is limited. Obviously once long-terms are issued, control over their maturity is lost,[10] and, to a lesser degree, the same is true for intermediate securities. If all outstanding issues were long-term, and if recession developed, the Treasury could do little to increase liquidity through debt management. In fact, however, some considerable amount of short-term securities must always be outstanding, regardless of business conditions, in order to meet legitimate needs of individuals and business. Flexibility in maturity distribution will derive mostly from the very short-term issues.[11]

Appropriate debt management easier in recession than prosperity

A shift toward short-term securities in recession will occur more readily than a shift toward long-term securities in prosperity. In recession the Treasury will easily be persuaded to issue short-terms because the interest charge on them will be low, and the banks, always the chief holders of short-term issues, will have idle reserves which they will wish to employ. But in boom a shift toward long-terms—and a shift in ownership from banks to nonbanks—will be more troublesome. At such a time the market demand for long-term capital is likely to be strong and the Treasury, if it is to sell its bonds, may have to pay a high rate of interest. Nonbank investors will be faced with many demands

10 Use of Consols—perpetual debt subject to unlimited call at the convenience of the Treasury—has, however, been suggested [Simeon E. Leland, "Management of the Public Debt After the War," *American Economic Review*, Supplement (June 1944), pp. 89-132]. Such securities would certainly require a relatively higher interest rate than those with a fairly firm date of redemption.

11 Long-term securities are, of course, susceptible to the influence of monetary policy, as short-term are not. Institutions and individuals holding the latter can soon secure cash by letting them come due. Withdrawal from long-term bonds, however, supposing monetary policy has become restrictive, will impose a penalty in the form of a capital loss.

for their savings and they may be somewhat oblivious of the merits of federal bonds bearing a low coupon.[12] In short, countercycle debt management in prosperity runs counter to the easiest and cheapest method of borrowing. This is, to be sure, also a problem of fiscal policy, since higher tax rates in time of prosperity may require a more sophisticated theory than Congress and the public will entertain.

In the years 1945-1951 the evidence is convincing that debt management by the Treasury was swayed strongly by budgetary considerations rather than by countercycle theory. Although inflationary pressures were powerful, debt management tended to maintain and even to increase liquidity. In refinancing maturing debt, the Treasury favored short-term issues. The amount of marketable bonds with a maturity in excess of five years held by savings banks and insurance companies fell from $28.3 billion at the end of 1947 to $15.9 billion at the end of 1951, while holdings of noninstitutional investors fell from $19.6 to $14.6 billion.[13] Against the budgetary saving which comes from the low interest rate on short-term issues should be set the responsibility for inflation. Indeterminate as this may be, it was surely large. In retrospect it would seem that the Treasury during those years should have been refunding short-term securities held by the banks by sale of bonds to the investing public. The higher interest rate would have been a reward to investors for foregoing liquidity.

After the "accord" in March 1951 debt management, as well as monetary policy, became somewhat restrictive and interest rates on federal securities rose. In 1953 the Eisenhower administration and the Federal Reserve pushed even more vigorously in the same direction.[14] In January the System raised rediscount

[12] When the Patman Subcommittee asked government security dealers in 1951 what types of securities should then be the vehicles of United States Government borrowing, most thought the market would favor short-terms and would absorb long-terms only at considerably higher interest rates. 82d Congress, 2d Sess., Joint Committee on the Economic Report, Subcommittee on General Credit Control and Debt Management, *Monetary Policy and the Management of the Public Debt, Replies to Questions,* Part 2, p. 1284.

[13] A. G. Hart, *Defense and the Dollar* (New York, Twentieth Century Fund, 1953), p. 103.

[14] A clear statement of debt management as a supplement to fiscal policy was given in the Budget Message to the Congress, January 21, 1954: "The problem of debt management is not only one of offering securities for cash

rates from 1¾ to 2 percent and, until May, aimed to restrain expansion in bank credit. During these same months the Treasury attempted to shift borrowing to longer maturities and away from the commercial banks. The most notable step was issuance in April of 25-30-year bonds at a yield of 3¼ percent, the first long-term marketable bonds since December 1945. Shortly thereafter inflationary pressures abated, and the Federal Reserve reversed its policies. By open-market purchases it provided the banks with additional reserves, and in February 1954 it reduced rediscount rates from 2 to 1¾ percent. The Treasury, meanwhile, harmonized its policy with that of the Federal Reserve by making no new issuance of long-term securities. Of a net increase of debt in 1953 of $5.4 billion (apart from $2.4 billion borrowed from government agencies and trust funds), about $4 billion was borrowed from nonbank investors. Holdings of federal securities by the Federal Reserve increased about $1.2 billion and by commercial banks only about $300 million.

This beginning at stretching out debt maturities and at shifting securities away from the commercial banks was halted by the business decline which started mid-1953. It is, moreover, under sharp attack as too abrupt and severe,[15] and as bringing on the nation an unnecessary recession.

3. DIRECT CONTROLS

The defects in peacetime

The assumption of this study is that *indirect* controls—fiscal and monetary policy—are compatible with the peacetime operation of a free-enterprise economy, but that *direct* controls, such as price ceilings, rationing, allocations, are not. In wartime, it should be appreciated, this incompatibility of direct controls vanishes because then the simple and overriding goal is speedy victory. The required amount of wartime goods must be secured more rapidly than market forces can provide. The market process

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or refunding which the market will take, but of appraising the economic situation and adapting financing plans to it, so that as far as possible debt management does not contribute to either inflation or deflation."

[15] 83d Congress, 2d Sess., Joint Committee on the January 1954 Economic Report, House *Report* No. 1256, pp. 19, 30.

will need to be superseded, with allocation of resources by decision. But in peacetime direct controls must be avoided because, in the long run, (1) they would probably be inefficient and (2) they would tend to destroy democracy.

Their inefficiency has several aspects. Direct controls restrict both consumer and producer choices. Whereas the market mechanism, via prices, allows individuals to buy and sell, and to allocate resources, by a process which is largely automatic, direct controls substitute governmental decisions. The decisions require complicated calculations in order to make sense, and, at best, they will have to be administered by arbitrary rules and red tape. The administrative cost of using direct controls is heavy, and to this amount must be added the cost of compliance which individuals would bear when they complied, and the cost of evasion which would fall upon them and the economy in general when they did not.

Direct controls in peacetime impair democracy because "wide areas of discretion must be left to administrative agencies."[16] Congress cannot spell out the details of a price-control or rationing scheme; it must allow power to frame details to the executive branch. Except in wartime, when the goal will be clear and the power will be short-lived, this will place citizens in the hands of government officials.

Let us look briefly at two major types of controls, price ceilings and rationing. The former will be imposed to control inflation. But if real shortages of goods exist, price controls will have to be supplemented by rationing and allocations in order to guide the flow of goods to the right persons and places. Thereby the inflation may be "suppressed." This can be done if the controls are well run, and if the amount of the suppression is moderate and does not have to be maintained too long. These "ifs" are not easy to achieve. When controls are threatened, the tendency is to respond with harsher administration; i.e., by a departure from democratic techniques or by yielding somewhat to inflation. In a democracy the latter is likely to be a first step as pressure groups force partial breaks in the controls. But these breaks create other pressures; they weaken administration and destroy what-

[16] Committee for Economic Development, *The Uses and Dangers of Direct Controls in Peacetime* (New York, 1949), p. 9.

ever consistency and symmetry the controls may originally have possessed.

The merit of over-all fiscal and monetary controls is that they avoid these dangers by minimizing interference with individual and business spending and, therefore, with allocation of resources by the market. Such controls can be built in to the existing fiscal structure; or they can be operated by Congress at its discretion; or they can be delegated by Congress to the Executive, subject to flexible modification.

3

Private Investment and Economic Instability

> The task of cyclical stabilization is difficult enough without the distraction of stagnationist soothsaying. It is not, however, impossible. To its accomplishment, haunted no longer by the demons of economic maturity, we can proceed with courage and resolution.—GEORGE TERBORGH.[1]

Unstable private investment creates economic instability

The most accurate brief statement that can be made concerning economic instability is that it rests upon the instability of private investment (including inventory). It moved from a high of 15.2 percent of GNP (Gross National Product) in 1929 to a low of 1.5 percent in 1932, and in 1953 it was 15.2 percent. Investment, in modern times, has proceeded by spurts, and it may well be that this manner of growth has brought a more rapid accumulation of capital than would any other. This growth of capital has been the prime foundation of a rise in living standards of the Western world beyond anything known before in history. But it has brought also economic instability of which the most tragic social manifestation is unemployment.

So long as unemployment was small in amount and short in its peak duration, the price seemed worth the cost. For the thirty-one years, 1900-1930, average unemployment was, perhaps, 2.7 percent of the labor force.[2] Within this period there were, of course, ups

[1] George Terborgh, *The Bogey of Economic Maturity* (Chicago, Machinery and Allied Products Institute, 1945), p. 226.

[2] U. S. Bureau of the Census, *Historical Statistics of the United States* (Washington, 1949), p. 65.

and downs. Marked *over*employment had characterized the war years 1917-1919, while the depression years 1908, 1921, 1922, showed unemployment of 6.3 percent, 11.2 percent, and 6.8 percent. In no case, however, had the period of heavy unemployment been prolonged. The record 1931-1940 was in shocking contrast. The *best* year (1937) of this decade had unemployment in excess of the worst year 1900-1930; the worst year (1932) of the decade had unemployment of 22.8 percent. This was so serious as to threaten social revolution, and it brought governmental assumption of tasks which hitherto had been an individual responsibility. For the first time in the history of the United States a serious controversy arose over the proper agenda of government.

Early in the depression the Hoover administration attempted to bolster employment by providing emergency aid to private business through such institutions as the Reconstruction Finance Corporation, which would provide liquid capital for faltering companies. This proved inadequate, and the Roosevelt administration very soon became involved in economic reform as well as economic recovery. Not only was there enactment of punitive and regulatory economic legislation, but the federal government also entered spheres of investment occupied hitherto by private business. Both steps were regarded by conservatives as threats to free enterprise. On the other hand, the sudden shift of the boundary between private and public areas of operation, and more specifically, the sudden enlargement of the public area, led some liberals to urge that the area of occupancy by government should continue to be enlarged, or at least that, with recovery, there should be no retreat. These people were motivated by fear of economic instability; they were seeking a remedy for mass unemployment even at the cost of some slackening of the rate of economic progress. If private investment lagged, public investment could be enlarged.

Rise of the doctrine of secular stagnation

The depression of 1937-1938 stimulated expression by economists of a sophisticated version of this philosophy. The pick-up in private investment after 1932 was timid, and, despite a great expansion of federal employment, the level of total unemployment remained high. Then in the fall of 1937 this restrained

recovery was halted by a sharp recession. The immediate occasion for its onset was, according to some economists, a decline in the net governmental contribution to total spending, and this result was held to give new support to the doctrine of secular stagnation. Full recovery had failed because private investment lagged behind savings. If a better outcome was to be secured in the future, government should stand ready to use its fiscal powers not merely to offset cyclical, but also secular, forces. Instead of cycle-balance in the budget, there should be a planned long-run increase in government debt. This increase, by contributing to fuller employment, would make a net contribution to national income.

An American statement

Two lucid, and extreme, expressions of the new doctrine will be illustrative. In 1938 "seven Harvard and Tufts economists" wrote:

> The expansion of the nineteenth and early twentieth century was based on building for the future, which carried with it an adequate demand for consumable goods and services in the present. When the limits of expansion had been reached . . . building for the future became an increasingly hazardous adventure. Its volume contracted and with it an ability to buy in the present. Expansion fed upon itself in the past; contraction feeds upon itself in the present. These are the basic factors which underlie the reversal of trend from 1929 to the present.[3]

According to this group the problem needed attack from two sides. One side was through redistribution of income in order to increase consumption as against saving; the other was to find new fields for *public* investment. Ironically enough it was claimed that "this program is designed to protect private enterprise . . . by restoring the demand for the products of private enterprise through a vigorous expansion of the public sector."[4]

A British statement

In 1937 a distinguished English economist, Joan Robinson, had taken a parallel position. She wrote:

[3] *An Economic Program for American Democracy* by Seven Harvard and Tufts Economists (New York, Vanguard Press, 1938), p. 22.

[4] *Ibid.*, p. 45.

> Since the increase in population is rapidly approaching its end in the western world, no fresh continents remain to be discovered, and a new age of invention comparable with the nineteenth century is scarcely to be hoped for, it appears that in the near future powerful stimulants will have to be applied to the economic system if chronic unemployment is to be avoided.
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> A long-run fall in the rate of interest would do much to stimulate private investment, while an extension of public investment could make up for its deficiencies, and a drastic policy of redistribution of income would increase consumption, and reduce the amount of investment necessary to preserve a reasonable level of employment. All these policies meet with serious difficulties and have to contend with violent opposition, and it remains to be seen whether it is possible for the present economic system to adapt itself to the requirements of the future.[5]

The key to the doctrine was consumption which could be stimulated via government spending and taxing. Spending was the favored, often the sovereign remedy, and proponents appeared to feel that, if one spoonful was good, two were twice as good. But taxing to reduce saving had a place. And not very consistently with the thesis that private investment was deficient, the tax programs in practice put penalties on business investment. Sometimes the theory behind such moves was socialism rather than secular stagnation.[6]

Postwar decline of the doctrine

Before World War II many economists, while remaining uncommitted to the doctrine of the mature economy, conceded that it *might* be correct and that account should be taken of it

[5] Joan Robinson, *Introduction to the Theory of Employment* (London, Macmillan & Co., Ltd., 1938), p. 123.

[6] This was *not* the position of Keynes. Indeed, one may doubt that the mature economy thesis is an organic part of the *General Theory*. With the outbreak of World War II, Keynes was the first to appreciate that the threat was inflation, and he applied his doctrine to that problem. I take at face value Keynes' assertion that his aim was to renovate the system of free enterprise. *General Theory of Employment, Interest and Money* (New York, Harcourt, Brace & Co., 1936), pp. 380-81.

Walter P. Engle argues that a program to meet cycle variation has quite different requirements from one to meet secular stagnation. The latter, he says, requires continuous income-supporting operations, whereas the former requires a flexible program, sometimes supporting and sometimes retarding. *Economic Stabilization, Objectives, Rules and Mechanisms* (Princeton, Princeton University Press, 1952), pp. 5-6.

in framing economic policy. But when the transition from war to peace after 1945 was accomplished with ease and rapidity; when succeeding years brought over-high employment, large investment, and rapid inflation; and when, in Western Europe, a great shortage of savings developed, the doctrine was moved quietly into the background. A few economists, notably Terborgh and Fellner, gave it a critical appraisal, and advanced the tentative conclusions that the technological limits to absorption of savings were remote; that the belief in secular stagnation stemmed from inaccurate and unhistorical generalizations drawn from the 1930's; that adverse political and economic policies then had been a serious obstacle to private investment.[7]

Secular exhilaration

Events in the postwar years, indeed, suggested secular exhilaration, rather than stagnation, as the prospect, although this generalization is as unprovable as its antonym. But if, in the years ahead, saving runs behind investment and creeping inflation is the trend, then a long-run program to stimulate savings would be logical. In terms of taxes, lowering of upper bracket rates, lowering the rates of the corporation income tax, removal or mitigation of double-taxation of dividends, liberalization of depreciation allowances, etc., would be appropriate. A more unusual approach would put the emphasis upon adding to the total of savings by governmental surpluses with use of these as subsidies for private investment. The government would, in such case, aim at surpluses (savings) which it would spend as grants to encourage investment by private industry. The precedent which comes to mind is the granting of money and of public domain to aid construction of the great railways. In the light of history, this is usually adjudged to have been wise; every federal dollar so spent attracted several more private dollars for capital outlay, economic progress was accelerated, the nation was knit together economically and politically. The program had, moreover, the advantage of requiring a minimum of governmental supervision. Possibly some similar scheme of direct subsidization could be developed once more. It would, as one economist observes, have the "su-

[7] Terborgh, *op. cit.*, pp. 213, 226; William Fellner, *Monetary Policies and Full Employment* (Berkeley, University of California Press, 1946), Chap. III.

preme advantage of stimulating those sorts of capital expenditures which, if expectations turn out well, would raise productivity and promote an increase in the output of the things consumers wish to buy."[8]

Neither secular stagnation nor exhilaration assumed here

The arguments presented in these pages depend neither upon the assumption of secular stagnation nor exhilaration; they do not assume that the long-run level of savings should be reduced or stimulated. Instead, the analysis is limited to countercyclical policies. *Within the cycle* sometimes consumption and sometimes investment is the tactical element to encourage or restrain because the flows of savings and investment may diverge, and this short-run divergence may be reinforced via the multiplier and the accelerator. Automatic stabilizers in the fiscal system are needed as shock absorbers, supplemented by discretionary fiscal policy action via government expenditures and tax rates to halt both inflation and recession. This view of fiscal policy tolerates instability and concentrates simply upon keeping the swings, especially of unemployment, within modest bounds. It does *not* attempt to determine long-run investment-consumption objectives. The actual long-run levels of investment and consumption will, of course, be affected by fiscal policy, particularly if it is successful. But this effect is a by-product and does not require governmental formulation of long-run objectives. It admits that the reasons for a particular recession or boom may be unknown, but argues that, nonetheless, off-setting action is feasible. Remedy, in short, does not require discovery of the causes of the disturbance. And the aim is not to keep the economy on an even keel; rather is it to hold swings within bounds. This modesty of aim is dictated by two conclusive considerations: (1) knowledge and techniques are inadequate to do anything more; (2) limited

[8] Seymour E. Harris (ed.), *Postwar Economic Problems* (New York, McGraw-Hill Book Co., 1943), chapter by Richard Bissell, Jr., p. 109. A type of investment parallel to this precedent would be hard to find, since no single industry exists comparable to the railways of a century ago. Today government at all levels provides directly, through highways, a much larger portion of the transportation facilities of the nation than in 1850. Direct public investment may be the trend of the future. But in the event of subsidization, two features are important—(1) that the grants carry no long-run strings, (2) that they be for long-run investments.

economic variation brings positive gains to a free-enterprise society.

A narrow approach to fiscal policy does not, however, deny that tax laws and all government policies which *directly* affect business decisions need to be appraised for their long-run effects. The implication is rather that the stabilization program should refuse to lean upon unprovable long-run forecasts. No matter what one may believe concerning the long-run prospects for the supply of saving and investment, long-run discrimination against one or the other may endanger the goals both of economic progress and stability.

Suggestions have often been made that, over the cycle, private investment might be somewhat stabilized by integration of *private* decisions. The Council of Economic Advisers, as will be indicated later, advanced this idea and was, indeed, prepared informally to promote it.

Stabilization of investment by private decision

The dangers of private action here are very obvious. Agreements to restrict investment would be evidence of the absence of competition and they might be made for purposes other than restraint of inflation. They would, in any case, be inherently insecure. When, in depression, a firm is confronted with (a) its prior loose commitment to make investment outlays and (b) its present expectation that this investment will be unprofitable, it would surely and properly ignore the former. Its commitment would rest upon assumptions of price-cost relations which no longer prevailed because a technique to forecast cycle changes in these relationships is not available. The essence of free enterprise is that individual firms be free to make and alter such decisions. Rigid commitments about future investment for the sake of the over-all *public* interest would impair the very character of the system.[9] Businesses could, indeed, frame and make public their *long-range plans* for investment, basing these upon projections of long-range market expectations, and knowledge of these plans

[9] It may be, however, that government could encourage and assist the public utilities to adopt stable long-term investment programs. They are, in the nature of the case, already so bound by and dependent upon governmental decisions that this further step might be desirable.

might diminish the sensitivity of investment to short-run market conditions.

Cost-reducing function of investment

The most important long-run function of investment in a free-enterprise system is to be cost-reducing. In the short-run, indeed, as the Keynesian theory stresses, the direct effect of investment is to increase or decrease employment and incomes; but in the longer stretch, as the classics stressed, by reducing costs (and prices) it releases income for new uses in consumption or investment, and it allows substitution of leisure for work. The first effect of successful investment is to increase business profits. Some considerable part of this increase should be passed on by way of lower prices and higher wages.

> Only in this way can the expansion of national income be made a continuing process, rather than one that needs increasingly to be propped up by public spending. How to absorb profits into higher wages and lower prices in a steady and orderly manner which business can tolerate without deflationary setbacks or the impairment of investment is the central problem.[10]

Solution will require a manifold program, of which fiscal policy is only one feature. But as one feature it might, by moderating the sensitivity of profits to cyclical swings, induce business to take a more long-run view toward investment.

It should, finally, be remembered that some of the past instability of private investment has been a result rather than simply a cause of the cycle. Perverse fiscal policy, in particular, must bear some blame. When in depression governments decreased expenditures and increased taxes, when in boom they did the opposite, cyclical swings in savings and investment were aggravated. A rational fiscal policy, while not eliminating, might set moderate limits to swings in national income and thereby reduce the instability of private investment. By promoting over-all stability of demand for the products of investment, the indirect contribution of fiscal policy to stability might be great. A successful fiscal policy might, besides, have the long-run effect of making investment more attractive and thereby of increasing its long-run level.

[10] John H. Williams in *Financing American Prosperity*, P. T. Homan and F. Machlup, eds. (New York, Twentieth Century Fund, 1945), p. 372.

4

Budgetary Balance and Unbalance

> A policy based on the principle of an annually balanced budget regardless of fluctuations in the national income . . . , if actually followed, would require drastic increases of tax rates or drastic reductions of Government expenditures during periods of deflation and unemployment, thereby aggravating the decline, and marked reductions of tax rates or increases of expenditures during periods of inflationary boom, thereby accentuating the inflation. A policy that will contribute to stability must produce a surplus of revenues over expenditures in periods of high prosperity and comparatively full employment and a surplus of expenditures over revenues in periods of deflation and abnormally high unemployment.—THE DOUGLAS REPORT.[1]

Surplus or deficit?

If a balanced budget means an equality between revenue and expenditure for a fiscal period, an unbalanced budget should mean either an excess of expenditure or a surplus of revenue. In common parlance, however, the meaning has been confined to the former with the implication that this sort of unbalance is undesirable, while unbalance by surplus is desirable.[2]

Some challenge to this opinion has, however, appeared in American history. When in the 1820's and 1830's the levels both of federal debt and taxes were very low, surpluses became a major problem, and, in 1826 a Senate committee could, without

1 81st Congress, 2d Sess., Senate Document No. 129, p. 1.

2 A more consistent terminology would be balanced, underbalanced, and overbalanced budgets.

levity, speak of "the serious inconvenience of an overflowing Treasury."[3] During the 1880's similar difficulties cropped up. A succession of surpluses flowed into the Treasury in circumstances which made it difficult to return them to the income stream. Federal debt was small and in the form of long-term bonds not subject to call. Purchase in the market lifted the price of the bonds well above par and gave windfall gains to holders; deposit of the surplus in the national banks raised the questions of safety of the money and of favoritism. Yet both of these dubious techniques were used on occasions, especially when bank reserves were running low. The Secretaries of the Treasury were carrying out a rudimentary type of monetary policy, with the Treasury acting as a central bank. These events led Henry C. Adams in 1887 to express a general preference for repeated deficits over repeated surpluses because "the moral effect" of the former upon electors and legislators was good.[4]

In some future decade it may be that the federal Treasury will again struggle with unwieldy surpluses, but currently its problems are just the opposite. Two great wars, a prolonged depression, the split of the world into two armed camps, have made a balanced budget, not to say surpluses, a difficult goal.

1. INTRODUCTORY CONCEPTS

Administrative vs. cash budget

The term federal budget is used commonly in two senses to describe: (a) the administrative or conventional budget and

[3] *American State Papers* (Washington, 1832), Vol. V, p. 502.

[4] Adams wrote as follows: "The moral effect of a deficit upon the electors as well as upon the legislators is good. The people will be more careful to exercise their constitutional prerogative in the control of expenditures if the minister of finance is obliged to use the language of poverty, than if they are made to feel rich by the portrayal of an ever-increasing surplus; the legislative body, also, will be more careful as to appropriations, if deficits stare them in the face, than if their deliberations are carried on in the presence of an overflowing treasury. There can be no more pertinent testimony to this claim than that presented by the history of the United States Congress during the last few years. Resting secure in the carelessness of a people conscious of being rich, and having at their disposal an enormous revenue, our national representatives have made appropriations which would have caused the downfall of any party had those appropriations rendered necessary an appeal to taxes, or even a resort to temporary loans." *Public Debts* (New York, D. Appleton & Co., 1887), p. 80.

(b) the consolidated cash budget. The latter, as the title suggests, shows all receipts from and payments to the public, while excluding intra-governmental transactions, notably interest on trust-account investment in federal securities. It excludes also noncash items, such as interest accrued on saving bonds which will not be paid in cash until the bonds are redeemed. At present the cash budget shows a larger surplus (or a smaller deficit) than the administrative budget chiefly because the trust funds for the social insurances currently are accumulating reserves; that is, benefit payments are less than contributions.[5] At some future date it is to be presumed that the situation will reverse and the cash surplus will be less than the budget surplus or, if both have deficits, that the cash deficit will be larger than the budget deficit.

Most economists, when thinking in terms of fiscal policy, regard the cash budget as the more relevant in its impact on the economy, and this view is accepted here. It is to be noted, however, that the correlation in time between cash spending and tax receipts, and their effects, is imperfect. Obligational authority to spend, for example, makes an impact on economic activity *before* the actual spending takes place; similarly, tax liability may have an effect before actual taxes are paid.

Single or multiple budget?

The federal budget is a single one, but it has been argued that "capital" items should be put in a separate budget and financed by borrowing. A capital item has been defined as one directly productive of revenue, e.g., a hydroelectric development, or, more broadly, as one which makes an indirect contribution, e.g., schools, hospitals, highways. Many nations have, at various times, set up extraordinary budgets to include these two types of "capital" expenditure, as well as unusual items arising out of emergencies. Candid appraisal discloses an extraordinary tendency for these budgets to degenerate into camouflage for a timid financial policy.

[5] In the fiscal year 1953 the figures for the two budgets were as follows:

	Cash Budget	*Administrative Budget*
	(billions of dollars)	
Receipts	71.3	65.2
Payments	76.6	74.6
	—5.3	—9.4

Unwilling to balance aggregate expenditure against revenue, governments crowd questionable items into an extraordinary budget, creating dead-weight debt. Even if such malpractices could be prevented, the merits of a capital budget are far from clear. It is not required for the *commercial* enterprises of government—those run on principles very similar to private business—because certainly each of them ought to have its separate budget for all transactions. The critical issue arises over exclusion of any *other* items from the regular budget, and here it may be that use of a capital budget is window dressing. In depression it *may* facilitate borrowing by misleading the public, or Congress, or both.[6] But sophisticated political schemes of this type should be suspect in a democracy.

Accounting period

Another technical issue relates to the length of the accounting period for the budget, and here the practice of national governments has been to set a single year.[7] A budget is measured for balance or imbalance within this precise time-period. The goal of annual balance can, to be sure, seldom be achieved with precision.

The budgetary process

A review of the budgetary process will indicate why a precise balance of expenditures and revenues cannot be achieved. The annual budget sent by the President to the Congress in early January, contains a statement of actual expenditure for the last fiscal year, estimates of expenditure for the fiscal year which is half over and for the fiscal year beginning the next July 1, and a much less detailed statement of receipts for the same three periods.[8] A comparison of estimated expenditures with estimated

[6] Paul Samuelson writes: "Two pools of money with widely differing net utilities at the margin violate all rational principles of allocation." *Money, Trade and Economic Growth* (New York, The Macmillan Co., 1951), p. 169. See also James A. Maxwell, "The Capital Budget," *Quarterly Journal of Economics* (1943), pp. 450-64.

[7] A shorter period is rare. Poland, on the advice of Sir Hilton Young is said to have used a monthly period. Hugh Dalton, *Unbalanced Budgets* (London, G. Routledge & Sons, 1934), p. 14.

[8] Estimates of expenditure, and even more of receipts, require that assumptions be made about the level of economic activity. The temptation is strong

receipts for the fiscal year beginning next July 1 shows surplus or deficit, supposing the estimates are correct, and, what is more important, supposing Congress grants the new obligational authority to spend which the President requests in his budget. If this requested obligational authority is enlarged or diminished, the estimates of expenditures will have to be revised up or down. The estimates of revenue assume existing tax legislation. If *new* tax legislation is enacted again receipts must be revised.

How does Congress proceed? The several appropriation bills are sent to the appropriate subcommittee of the Appropriations Committee, and each is reported *separately* to House and to Senate. At no time does either body bring together and consider as one piece all the appropriation bills. Congress does not know when it votes each bill what is the total of the new obligational authority or the total estimated expenditure. In short, after receipt of the Budget, Congress does not again get a look at its aggregate spending; it cannot, therefore, relate spending to receipts with any precision in a particular year so as to secure balance (or imbalance) in the annual budget.[9] Nevertheless, the *goal* at which Congress aims is important. Moreover, the Bureau of the Budget does appraise requests for appropriations quite precisely with respect to their effects on annual expenditure, and the goal at which it aims (acting for the Executive) is also important.

Why annual balance?

The argument of proponents of annual balance is chiefly negative. It is that, once their principle is abandoned, political irresponsibility will be generated. As sixteen distinguished economists have recently pointed out, annual budget balancing has the one great merit that

> it provides a yardstick by which legislators and the people can scrutinize each activity of government, testing it both for efficiency of

to assume continuation of current levels. Assumption of recession eighteen months ahead is obviously unpalatable; assumption of boom, on the other hand, leads to the charge of undue optimism. Proponents of the position that government must be responsible for maintenance of full employment argue, therefore, that budget estimates should rest upon a full-employment assumption.

[9] Two attempts at remedy have been made in recent years: (a) by the Congressional Reorganization Act of 1946; and (b) by the consolidated appropriation bill. Both have been complete failures.

> operation and for its worthwhileness in terms of cost. Every Government program undertaken has to be paid for in a clear and unequivocal sense. The legislature and the Executive are required to justify additional taxes equal to the cost of any new program. This is a principle every citizen can understand. If dropping the principle of annual budget-balancing were to mean dropping all restraints to unwise and inefficient expenditure, grave damage would be done to our economic and political system.[10]

More specifically, the damage would be (1) uneconomical expenditure and (2) accumulation of debt.

Defects of annual balance in recession

The defects of annual balance, on the other hand, are intimately related to the fact of cyclical instability. Consider first the case of recession, assuming the aggregate of federal spending to remain unchanged. Since the incomes of individuals and businesses will then decline, so also will tax receipts, creating a deficit. If, in order to balance the budget, tax *rates* are raised, individuals and businesses will have to pay larger taxes out of smaller incomes. Their power to spend will shrink not only because of the recession, but also because of higher taxes. The tax increase serves, therefore, to deepen the original recession by reducing aggregate spending. But why, it may be said, should not government in recession reduce its own spending in order to balance the budget?[11] If it does, the effect will similarly be to reduce the receipts of individuals and businesses and, therefore, their power

[10] "Federal Expenditure and Revenue Policy for Economic Stability," Joint Committee on the Economic Report, 81st Congress, 1st Sess., *Hearings*, pp. 6-7. In collaboration with the National Planning Association, the Joint Committee in September 1949 held a conference at which the above statement was developed. The Swedish government has a system by which one fifth of a year's deficit is charged to the next year. The objective is to compensate (arbitrarily) for the uncertainty of the rule of cycle balance.

[11] This opinion has a long background and one typical expression will be given. President Cleveland in a message to Congress on December 4, 1894, said: "At this time when a depleted public Treasury confronts us, when many of our people are engaged in a hard struggle for the necessaries of life, and when enforced economy is pressing upon the great mass of our countrymen, I desire to urge with all the earnestness at my command that Congressional legislation be so limited by strict economy as to enlist an appreciation of the condition of the Treasury and a sympathy with the straitened circumstances of our fellow-citizens." *Messages and Papers of the Presidents, 1789-1902*, James E. Richardson, ed. (Washington, 1903), Vol. VIII, p. 458.

to spend. The likelihood is, however, that government will be forced by recession to *increase* its expenditure. To balance the budget would then aggravate the situation of individuals and businesses even more than in the case first discussed. In all three situations the act of budget-balancing would be perverse; private power to consume and invest would be weakened when a strengthening is desirable.

Defects in boom

Is annual balance a good rule for years of boom? Private incomes are then expanding and, as a result, government is likely to run a surplus. If the level of expenditures is kept unchanged, balance could be restored by reduction of tax rates, thereby adding to individual and business incomes and stimulating expansion of consumption and investment when, by assumption, it is already vigorous. The same result would follow if balance is achieved by an increase in government expenditure. A balanced budget would push the economy toward inflation.

These facts are recognized by proponents of the principle of a balanced budget and their *practice* has been to tolerate modest deficits in depression and modest surpluses in boom. This practice is subject to the charge that it merely softens the faults which arise out of strict application of their principle. Unless their fears of uneconomical expenditure and of accumulation of debt are valid, the interests of economic stability will be served by pursuit of a conscious program of substantial deficits in depression and substantial surpluses in boom. Only in "normal" times when the economy is stable, prosperous, and heading neither toward boom nor depression, is balance a rational aim. In a normal year, if Congress wishes to make increases (decreases) in expenditures, it should match these with increases (decreases) in tax receipts. A marginally balanced budget would result, a tax test being applied to all marginal outlays or reductions.[12]

[12] This is the position taken in "Federal Expenditure and Revenue Policy for Economic Stability." Paul Samuelson has since argued that, as a check to governmental extravagance, this is too weak because an inflationary bias will be left in the budget. According to the balanced-budget theorem, so long as the private marginal propensity to spend is less than unity, private disposable income must be reduced by more than the increase in government expenditure—specifically by the increase divided by the marginal propensity

2. *WILL DISCARD OF ANNUAL BALANCE BRING UNECONOMICAL SPENDING?*

Meaning of a cyclically balanced budget

If the budget is to be underbalanced in depression and overbalanced in prosperity, will this bring balance over the cycle? Cyclical balance in the budget cannot be defined with the same precision as annual balance because the time period of a year is definite, whereas that of a business cycle is not. Assuming that only "major" cycles are meant and that their average duration is a "little over eight years,"[13] the range may be from six to twelve years with no regular periodicity. In such circumstances cyclical balance is a much vaguer concept than annual balance. Literal acceptance of cyclical balance might indicate that the Bureau of the Budget be asked to prepare, and Congress to pass upon, prospective expenditures and revenues for the span of a cycle. Both politically and administratively this would be hopeless, and most advocates of fiscal policy are content to continue with preparation, examination, and passage of annual appropriation bills. The relevant question is: Would less rigorous tests be applied than when annual balancing of total expenditure against revenue is the goal? In particular, would standards be slacker in recession, since deficits then will have positive economic merit? Some theorists, inspired by the sardonic remarks of Keynes about pyramid building and gold mining, have pressed the point that, in depression, even wasteful spending is defensible by the test of its effects on national income. But no policy-making official is likely to sponsor this opinion, and economists, when offering advice directly to Congress, have usually been emphatic in affirming that compensatory spending in recession should not be wasteful spending.[14]

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to spend. This follows because the government spends *all* that it receives, whereas private persons from whom tax collections are made would have spent only part. Besides, Samuelson objects to bracketing proposals for expenditure with tax proposals. *Money, Trade and Economic Growth, op. cit.*, pp. 167-68.

[13] Alvin H. Hansen, *Fiscal Policy and Business Cycles* (New York, W. W. Norton & Co., 1941), p. 18.

[14] The sixteen economists who signed the document "Federal Expenditure

Flexibility of program evaluation by Budget Bureau

The job of assessing the absolute and relative merits of requests for appropriations falls upon the Bureau of the Budget, and this is necessarily a long process which cannot ordinarily be telescoped without impairing its effectiveness. There are, however, types of expenditure, for example that for public works, which can be appraised and then deferred. A shelf of projects can be built up in good times and drawn down in recession. Precisely how this could operate will be considered in detail later. The point to be made now is that a decelerated and accelerated spending program of this type can be arranged without injury to the budgetary process of program evaluation. There is, moreover, some play in other programs. Recently the practice has been to establish early in the annual budgetary process a tentative ceiling for the budget as a whole, with subceilings for major programs, so that the Budget examiners have a rough guide concerning the standards of severity in appraisal which they should apply. Higher ceilings permit enlargement of appropriation requests with no impairment of the budgetary process. Conversely, lower ceilings indicate that the examiners should bear down on requests, and again this could be done with no impairment of the process of program evaluation.

The federal budget has within it, as will be shown later, certain built-in flexibilities. Expenditure for some programs will expand and contract automatically with recession and boom; in such cases the issue of impairment of the budgetary process does not arise because the criteria for expenditure have been established in advance.

Merit of contingency appropriations

Some economists, however, doubt that these flexibilities—built-in or designed—would allow rapid and adequate increase of expenditure in recession; they have, therefore, suggested more radical departures from existing procedures. One scheme would have

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and Revenue Policies" declared: "If a flexible fiscal policy is to win acceptance, it must not be used as an excuse to introduce expenditure or tax programs that cannot be justified on their merits. Boondoggling should have no place in a rational fiscal program." (p. 7.)

the Executive branch prepare, in addition to the regular appropriations, requests for *contingency* appropriations. These contingency appropriations would be utilized only through specific presidential sanction. A variant would be to have appropriations for public works and development projects made on a five-year basis with presidential discretion to vary the rate of spending inversely to cyclical changes. An annual report would be made to Congress concerning how far expenditures and obligations had exceeded or fallen short of the scheduled program, and Congress, upon yearly consideration, could revise its authorization for the succeeding five years.[15]

Advance planning by the Executive

These schemes, and others like them, aim essentially at some modification of existing budgetary procedure in order to overcome or circumvent possible bottlenecks which might block prompt action in depression. If, as may be guessed, the Executive is unlikely to ask for such modification, or the Congress to accede if asked, the Executive branch is not debarred from action on its own. It can shorten the time between its recognition of the need for increased spending and Congressional grant of appropriations by advance planning. The Executive branch should know in advance and in accurate detail what it wants to recommend to Congress in the event of recession so that time will not then be lost in preparation of specifications, in drafting, and in clearance. A well-thought-out program, promptly presented, is, furthermore, likely to be handled with expedition by Congress.

Program evaluation by Congress

In the above discussion of program evaluation, attention is focused on the performance of the Bureau of the Budget. What of the performance of the Congress? Would not its appraisal of appropriation requests be impaired by a belief that in recession deficits are desirable? Congressional restraint in spending grows out of its association of spending with taxing. If in recession the two are divorced, will not its resistance to spending deteriorate?

As has been indicated, Congress does not now get a chance to

[15] Harold D. Smith, *The Management of Your Government* (New York, McGraw-Hill Book Co., 1945), pp. 93-98.

appraise the annual total of appropriations which it makes because it passes appropriation bills as they are reported, one by one. Furthermore, the technical job of evaluation of spending requests is badly performed by Congress. Nobody who has sat through, or read through, Appropriation *Hearings* can fail to conclude that rigorous appraisal of the relative merits of programs depends chiefly on the Executive branch. Congress, as now organized, has neither the time nor the knowledge to do such a job. Its cuts and its additions to appropriation bills are haphazard, impressionistic, pressure-motivated.[16]

A cyclical budget and increase of debt

Yet Congress does have an important influence in determining the level of spending. Faulty as its appraisal of programs may be, it has the decisive authority. If Congress is impressed by the desirability of increasing expenditure (and lowering taxes) in depression, but not by that of limiting expenditure (and raising taxes) in prosperity, the budget will be unbalanced over the cycle. Since the precise period of the cycle cannot be defined, Congress may reckon fewer years as prosperous than as depressed, with some net increase in federal debt as a result.

Tax-induced deficits by-pass problems of program evaluation

Deficits can be the result of decreased taxes as well as of increased expenditure, and surpluses can be secured by increasing taxes as well as by decreasing expenditure. The tax method would by-pass entirely the problems of budgetary procedure and program analysis associated with appropriations. Simple tax bills altering the per-capita exemption and the first bracket rate, require no detailed and time-consuming Congressional appraisal. Congress might, indeed, be slow or fast in acting upon Executive recommendations of this sort for political reasons, and schemes have been proposed by which power to act is delegated by Congress, in advance, to some acceptable person or body. Whether or not this is desirable or feasible, tax changes are a more flexible

[16] Senator Paul H. Douglas writes: "At the present time Congress does not have facilities for making sound decisions on spending issues." *Economy in the National Government* (Chicago, University of Chicago Press, 1953), p. 68.

method than expenditure changes of securing deficits and surpluses. They do not, however, avoid the problem of Congressional bias in favor of deficits. It may be that Congress will be more inclined to lower taxes in depression than to raise them in prosperity with a net increase in federal debt as the outcome.

The conclusion is, therefore, indicated that fear of uneconomical expenditure seems unfounded, but that fear of debt increase is not. Might the outcome be deterioration of federal credit?

3. *WILL DEBT INCREASE IMPAIR FEDERAL CREDIT?*

Federal credit sturdy in the twentieth century

An enormous disparity of opinion exists concerning the sensitivity and delicacy of the federal credit. The evidence of history is that, in the past, it has been delicate. In 1842, after many state governments had defaulted, an attempt to float a federal loan in Europe at 6 percent failed, although the federal government had almost no outstanding debt. Until World War I, because of the rudimentary nature of the fiscal system, the scarcity of savings, and the "mores" of the society, federal credit appears to have been a sensitive plant. The war brought a transformation. Startling deficits were financed with no appreciable deterioration in ability to borrow. Not only was there firm confidence in the stability of the government, but the public became aware of the power of government, aided by a central bank, to transfer resources with efficiency from private to government use. In short, taxable capacity grew and so also did public appreciation that it had grown.

Some people found an explanation in the fact of war, declaring that the spur of patriotism made citizens unusually willing to buy government bonds and to endure tax burdens. But the depression after 1929 undercut this argument. Despite gloomy prognostications of many observers, large and continuous deficits did not impair federal credit. Indeed, interest rates fell and it seemed that the more the government borrowed, the lower the rate of interest it had to pay.

Differences of public and private debt

A major reformulation in doctrine took place[17] which stressed that public debt was *different* from private debt: that an internal public debt was not a debt at all, that the purpose for which public debt was incurred was very important, that the limits of public debt were set by taxable capacity, that the effects of public borrowing depended upon the state of the economy with respect to employment. Recently there has been some retreat from these propositions, chiefly because the large federal debt seemed to inhibit the exercise of an effective monetary policy by the Federal Reserve System and, as a result, the nation suffered inflation. Besides, the old generalization was rediscovered that internal debt creates indirect burdens since interest payments are not matched, person for person, with tax payments and since the transfer distorts effort and investment.

Attitude of policy-making officials

In any case, policy-making officials have never been so sure as academic economists of the toughness and resiliency of public credit. For example, the British White Paper of 1944 on Employment Policy (Cmd. 6527) expressed doubts about planned deficits. The government, it thought, should "have equally in mind the need to maintain the national income [by compensatory spending] and the need for a policy of budgetary equilibrium such as will maintain the confidence in the future which is necessary for a healthy and enterprising industry." To some economists the notion that maintenance of national income and of budgetary balance were "equally" important was absurd. A peacetime growth

[17] The extent to which this had to wait on the *General Theory* can be appreciated by examining *Unbalanced Budgets*, edited by Hugh Dalton and published in 1934. Dalton was uninhibited by doctrines of "sound" finance, yet the only concept of countercycle deficits which finds vague expression relates to public works. Dalton avows a personal opinion that freedom from "the plague of recurrent booms and slumps can be found only in a Planned Economy" (p. 458). A number of propositions contradictory to countercycle policy are expressed. Deficits are declared to be "a bad business" (p. 15); nations are chided for a lack of originality in finding new taxes and for hesitation in increasing old ones (p. 436); the argument that high taxes cause depression, and may deepen depression, is declared to be "false" (p. 437); the fear is expressed that unbalanced budgets may cause inflation (p. 437). All of this was at a time when national debts were at a very low level.

of national debt to achieve full employment, rather than increasing the tax burden, would reduce it. This was so even if the borrowed money was "spent on objects of current consumption, or on completely useless purposes, such as digging holes and filling them up again." An internal debt required only transfer payments and the only important reason why such debt should not be incurred was that the number and wealth of *rentiers* should not be increased.[18]

This carefree attitude may be contrasted also with that of Secretary of the Treasury Snyder. During the Hearings of the so-called Patman Subcommittee on General Credit Control and Debt Management in March 1951, Senator Douglas questioned the Secretary about the desirability of and necessity for Federal Reserve support of federal bonds, or whether a "natural" market would not be adequate. He asked:

> Is not the best protection for security issues the general prosperity of the country, a balanced budget, protection against the danger of further inflation, and a satisfactory interest rate? If those conditions are met, to what degree is it necessary for artificial support to be given by the Federal Reserve System?

The Secretary was cagey in his answers. You would have

> to consider the public interest involved. With the large financings that we have to conduct in these days, with the debt the size it is, there must be some assurance mutually agreed on between the Federal Reserve and the Treasury that these operations will be carried out with assurance as to the stability of the Federal Government bond market.

When asked by Representative Bolling what would be the effect on the economy of "a substantial falling off of Government bonds," he replied:

> That is a question I would like to answer in executive session, because I am the one and only person that is responsible for the final decisions on debt management. . . . To discuss things of this sort in an open session—I cannot measure what the effect might be.[19]

[18] William H. Beveridge, *Full Employment in a Free Society* (New York, W. W. Norton & Co., 1945), p. 148, 400. The author of the quotation is Nicholas Kaldor.

[19] 82d Congress, 2d Sess., Joint Committee on the Economic Report, Subcommittee on General Credit Control and Debt Management, *Hearings*, pp. 15, 17, 41.

Throughout the *Hearings* the key words for the Secretary are "confidence" and "caution." "A stable and confident situation in the market for Federal securities is our first line of defense on the financial front, no matter what may be ahead of us."[20]

Effect of public credit on fiscal and monetary policy

Behind the caution of policy-making officials lies the fear that in some future contingency government needs for borrowing might not be met. Even more relevant for present purposes is the fact that a government, unpossessed of public confidence in its credit, is thereby debarred from rational use of fiscal policy. In the face of unemployment it cannot expand government spending, or lower tax rates, or liberalize credit, because such action may "detonate" inflation by creating expectations that expansion will get out of hand. Government becomes relatively impotent. Instead of operating by fiscal and monetary policy upon the actual demand for goods and services, it must give major attention to pathological private expectations.[21]

Viewed historically, the handling of the federal debt by the Executive and the Congress has been conservative. Except for the 1930's, the peacetime effort has always been to decrease the debt, usually at a rapid rate. Table 1 shows the highs and lows of gross federal debt over a century and a quarter. The highs come at the end of major wars, subsequent to which reduction has been rapid. In the 1920's the *annual* rate of reduction in relation to national income was 1.12 percent.

Level of federal debt not determined by fiscal policy

This conservative tradition and strong official sentiment weigh against appreciable peacetime increase in the federal debt, even after allowance is made for a Congressional bias, in pursuit of countercyclical policy, toward deficits. At most, this bias may

[20] *Ibid., Monetary Policy and the Management of the Public Debt, Replies to Questions, Part 1,* p. 67. From a letter to the Chairman of the Board of Governors, July 17, 1950. Critics of Federal Reserve support of the market for government bonds argued that this policy had contributed to inflation. They paid little attention to the deduction that inflation could be dangerous to government credit.

[21] See the instructive discussion by R. M. Bissell, Jr., "European Recovery and the Problems Ahead," *Proceedings of the American Economic Association* (May 1952), pp. 306-26.

serve only to retard debt reduction. In the future as in the past, the course of events, especially war and peace, are likely to determine the level of federal debt.[22] Pursuit or nonpursuit of fiscal policy will, in this respect, not be influential.

Table 1. HIGHS AND LOWS OF GROSS FEDERAL DEBT

Year[a]	*Amount (in millions)*	*Per Capita*
1815	$ 127	$ 14.21
1834	—	—
1866	2,322	75.42
1893	961	14.36
1919	25,235	242.54
1930	15,922	131.51
1946	269,422	1,905.42

Source: *Annual Report* of the Secretary of the Treasury for the fiscal year 1953, pp. 384-85.

[a] December 21 in 1815 and 1834; otherwise June 30.

4. A CLOSER LOOK AT THE MEANING OF BUDGETARY BALANCE, SURPLUS, AND DEFICIT

Expenditure for goods and services vs. transfer payments

In these pages, following customary practice, fiscal policy will be described as aiming for a budgetary surplus, deficit, or balance, in order to secure an effect on the economy which is deflationary, expansionary, or neutral. The assumption is that a given amount of government expenditure will expand demand as much as the same amount of tax collections will contract it. In fact, a vast number of refinements are possible of which only a few will be indicated. One may ask, for example, what is *done* with a surplus? How is a deficit financed? Obviously the effects of a given surplus will be different if it is put on deposit with the Federal

[22] Arthur Smithies in defense of the position taken in "Federal Expenditure and Revenue Policy for Economic Stability," *op. cit.*, p. 2102, declared: "We do feel . . . that the policy we recommend here will not result in any greater increase in the national debt than any other policy that might be adopted."

Reserve Banks than if it is used to retire government debt held by individuals. Similarly, the effects of a given deficit will be different if it is financed by issue of new money than by sale of securities to individuals. Most refinements of this type relate to monetary policy and debt management. Their techniques, in order to be consistent with fiscal policy, should be expansionary, contractionary, and neutral in concert. The effect of fiscal policy can be offset, or reduced, by a monetary policy which has opposite pulls. A contractionary fiscal policy, evidenced by a large surplus, might be dampened by a monetary policy which allows individuals and businesses access to easy credit; *per contra,* deficits might be counteracted by a tight monetary policy.[23]

Effect of fiscal policy upon consumption, saving, and investment

A much important refinement for purposes of fiscal policy examines the effects of taxes (and spending) on consumption, investment, and saving. Different kinds of tax systems and taxes have different effects. Assuming a "normal" year and a given level of national income, the effect of a tax which falls on persons with a high marginal propensity to consume (*mpc*) will be almost wholly on consumption; that on persons with a low *mpc,* on savings. Similarly government *payments* will affect consumption and saving accordingly as the *mpc* of recipients is high or low. A balanced budget with a tax system consisting of excises on necessities and with expenditure mostly for debt service and redemption, will be more restrictive in its effects on consumption than one with revenues derived from income taxes on high incomes and with expenditures mostly in the form of salary payments to government employees. By analogous reasoning it is easy to see that the former type of budget, though balanced, might be more restrictive of consumption than the latter type with a surplus; and a balanced budget of this latter type might be less restrictive than a budget of the former type with a deficit.

[23] Recent illustrations come to mind. In the first half of calendar 1948 the federal surplus ran at the yearly *rate* of $12 billion, yet the currency continued to expand. Monetary policy was easy and both individuals and businesses had substantial liquid assets. The net outcome was inflationary pressure. The cut in surplus in the second half of the year did not cancel out recessionary influences, although it must have helped.

The above considerations are redistributive. A transfer of income from poorer to richer by regressive taxation, the proceeds of which are used as interest payments on federal debt, has restrictive effects on consumption; the opposite process has expansive effects. And a restrictive effect on consumption means, at a given level of income, an expansive effect on savings, while an expansive effect on consumption means a restrictive effect on savings. What if savings are spent at once for investment? Then the assumption of a given level of income is unrealistic if the investment is cost-reducing. And if the business cycle is taken into account, the assumption is even more unrealistic. As will be seen later, the redistributive effects of the fiscal system are limited, supposing attention is confined to revenue-expenditure changes which are practicable in the United States. This follows because the current level of federal spending is high and because the tax system cannot readily be made more progressive.

Method of finance important for expansive effects

For fiscal policy the *major* effects of balanced and unbalanced budgets depend upon the stage of the cycle in which the economy happens to be. If appreciable unemployment prevails, an addition to aggregate demand by increased government spending would, in most circumstances, have an expansive effect on employment and incomes. The expansive effect—the multiplier—will be larger or smaller according to the method used by the government to secure the money for its increased expenditure. If the money is not taken from anyone—if it comes wholly from a new addition to the money supply—the expansive effect will not be dampened down. If it is provided by taxation, or by borrowing from savings, the expansive effect *will* be reduced. But it will not be zero. Even if the new expenditure is financed wholly by new taxes, and even if the reduction in consumption and savings brought by the new taxes is equal to the increase in consumption and saving by the recipients of the new expenditure, the GNP will have been increased by the amount of product due to the newly employed resources.[24]

[24] If the new expenditure is entirely for make-work, this conclusion does not follow, although current techniques of computation of GNP would fail to disclose the discrepancy because these techniques assume an equivalence

It is, however, certain that this way of securing an expansive effect has several handicaps. The reduction in the size of the multiplier means a smaller increase in GNP and employment than would otherwise be obtained. Moreover, if taxation is already heavy, resistance to increases will be strong and this may bring adverse effects on production and investment. If high employment is assumed, all of these considerations are reinforced.[25]

Restrictive effects of a surplus

The restrictive effects of an overbalanced budget—of a surplus—also arise from their effects on consumption, saving, and investment. An excess of tax collections in prosperity can be expected to affect investment by affecting incentives and also the availability of investment funds; it will affect consumption by reducing incomes, and, if the taxes used are excises, by penalizing consumption. Should the new taxation imposed in prosperity be designed to strike at both consumption and investment, and in what proportions? No certain answer can be offered, but the likelihood is that most weight should fall on consumption. The aggregate of consumption will run four or five times that of investment and, for this reason alone, the restrictive effect of new taxes on investment will not be enough to repress inflation.[26] Considerations of equity which otherwise might count against taxation of consumption, are less forceful when incomes and employment run high, and, besides, restraint of inflation is itself in the interests of equity.

As will appear when particular taxes are considered, our knowledge of the effects of taxes and spending on consumption,

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between the value of production and of factor payments. This is important in appraisal of the merit of make-work for fiscal policy.

[25] The so-called balanced-budget theorem shows, however, that even assuming high employment and an incremental revenue-expenditure process which is neutral with respect to distribution (i.e., that the individuals paying the new taxes save and consume identically with those who are the recipients of the new expenditures), the net effect will be inflationary. The new government spending adds directly to the value of the GNP, even if a multiplier of one is assumed. Only if the new taxes serve to make a net reduction in consumption and government expenditures will some inflationary effect be avoided. See Haskell P. Wald, "Fiscal Policy, Military Preparedness, and Postwar Inflation," *National Tax Journal* (1949), pp. 51-62.

[26] In 1952 gross private investment was $51.4 billion, consumption $216 billion.

saving, and investment is imprecise, and so also is our knowledge of timing and lags and leads. Moreover, within our tax system a shift of emphasis in particular taxes—the "mix"—is limited. *Aggregate* collections and disbursements can be controlled and varied much more readily. This means that the concepts of surplus, deficit, and balance are satisfactory for most practical purposes.

5

Full Employment

> If attention is focused upon full employment, the collectivists will win hands-down, both in the battle of campaign promises and on the empirical evidence. Authoritarian societies can and do out-perform libertarian societies in terms of the amount of work or employment (including "forced labor"). Devotees of freedom should stress, not full production (which is the forte of military dictatorship) but efficient balanced production for humanitarian welfare and peace, domestic and international.—HENRY SIMONS.[1]

> There is no unemployment in the Union of Soviet Socialist Republics, and full employment of the population is assured.—OFFICIAL ANSWER BY THE U.S.S.R. TO A QUESTION FROM THE UNITED NATIONS.[2]

1. ITS EMERGENCE AS A GOAL FOR GOVERNMENT

Classical assumption of full employment

The classical economists did not theorize about unemployment whether arising out of secular stagnation or the business cycle. Technological progress, they assumed, tended to outrun the supply of savings, and this precluded the concept of secular stagnation and made depressions of short duration. Intervention by government to remedy unemployment was not indicated. Government had the duty of providing a limited parcel of very important functions, but extension beyond this narrow sphere

[1] Henry Simons, *Federal Tax Reform* (Chicago, University of Chicago Press, 1950), pp. 12-13.

[2] United Nations, *Problems of Unemployment and Inflation* (New York, 1950 and 1951), p. 145.

was wasteful, i.e., the marginal social utility of public expenditure soon reached a point where it was less than the alternative *private* use of the same amount of resources. This grew out of the characteristic that public expenditure was mostly for consumption, rather than for provision of durable goods.[3] Expansion of public expenditure, even if it increased consumption and employment, might do so at the expense of capital formation and growth. And classical theory, in a reaction from Mercantilism, would not tolerate make-work. In its interpretation of history the great wastes had come from uneconomical use of limited resources rather than from unemployment.[4]

Prewar and postwar events challenged this assumption

This interpretation was challenged by the sequence of events in the decade of the 1930's and 1940's—the former with severe cyclical unemployment, the latter with labor shortages. The contrast was too striking to be lost to public consciousness. If everyone could have a job in wartime, why not in peacetime? If governmental intervention secured full employment in the one case, why not in the other? Economists with an interventionist bias offered postwar programs, of which the best known is that of Sir William Beveridge, adapting the techniques of war to the ends of peace. Aiming straight at the goal of full employment, they favored the technique of government spending, reinforced by redistributive taxes and direct controls. Behind their thinking was the dominant premise that unemployment was incomparably the worst misallocation of resources. Protection of citizens against mass unemployment should become as definitely a function of government as provision of national defense and internal security.[5]

[3] Most of the services of the officers of government, said Adam Smith, like those rendered by churchmen, lawyers, and physicians, "perish in the very instant of their performance"; they do not fix themselves in a vendible commodity. Herein lay the distinction drawn by Smith and J. S. Mill, between productive and unproductive labor.

[4] Bertil Ohlin, writing in 1937, held to this opinion. "There is," he declared, "no evidence or indication in the economic history of the last hundred years that the waste from incomplete employment has been greater than have been the losses from uneconomical lines of economic activity." A. D. Gayer (ed.), *The Lessons of Monetary Experience* (New York, Farrar and Rinehart, 1937), p. 319.

[5] Sir William Beveridge has stated: "It must be a function of the State in future to ensure adequate total outlay and by consequence to protect its

Some economists had doubts, which increased as the years passed. They cited other goals than full employment, such as price stability, employment at useful work, stabilized economic progress; and many questioned whether the modifying clause in Beveridge's title *Full Employment in a Free Society* was consistent with the techniques which he urged. Rather was it likely that the outcome would be a *controlled* society with government allocation of resources, including labor. In this event the sacrifice might be both political freedom and long-run economic progress.

Of the alternative goals, the oldest in point of advocacy was price stability. Before the great depression many people believed that it could be achieved by monetary policy alone. The avalanche after 1929 disclosed the weakness of this instrument both in halting depression and in stimulating recovery. The excuse was offered (it can always be offered with a show of reason) that monetary policy failed only because it was not used with force and efficiency. But this excuse was soon submerged by the chorus of approval of fiscal policy. Even if the *goal* were price stability, the *instrument* of fiscal policy came to be favored. Some eclectics advanced a dual goal—stability of employment and of prices—with loss of employment giving the signal of a downturn and a rise in the price index of inflation. A program of this sort shades indistinguishably into one for maintenance of economic stability. In 1944 Marriner S. Eccles, as Chairman of the Board of Governors of the Federal Reserve System, supported a declaration that government

> action be directed toward the goal of stabilized economic progress, with the greatest possible encouragement to individual initiative and private enterprise and with the fullest sustainable employment of labor. The Government, therefore, should be concerned primarily with such measures and policies as would create a climate favorable to private enterprise and private employment and would prevent the irreparable losses resulting from deflation and inflation.[6]

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citizens against mass unemployment, as definitely as it is now the function of the State to defend the citizens against attack from abroad and against robbery and violence at home." *Full Employment in a Free Society* (New York, W. W. Norton & Co., 1945), p. 29.

[6] 79th Congress, 1st Sess., Senate Committee on Banking and Currency, *Summary of Federal Agency Reports on Full Employment Bill,* Print No. 1, p. 48.

More recently (in 1949) a group of sixteen economists, with the goal of "stable prosperity" in mind, argued that a downswing should be judged by the number of unemployed and an upswing by a rise in the retail price index "by over a certain amount in the preceding 6 months."[7]

2. *MEANING OF FULL EMPLOYMENT*

Unemployment and make-work

Advocates of full employment admit readily that "full" does not literally mean "full" and that "employment" does not mean just that, regardless of the type of work. Beveridge, for example, rules out "employment which is merely time-wasting, equivalent to digging holes and filling them again, or merely destructive like war and preparing for war."[8] The existence of unemployment is not to override the presumption in favor of directing resources into economic channels. But some writers are less positive; the objective of employment is allowed to *impair*, if not to override, any other criterion. The logic of their position that unemployment is the greatest waste allows make-work to be tolerated over idleness (even with a dole). This conflict is important because it limits the scope of what can be done through government spending. Unless the agenda of government is to be expanded, economic spending on public works reaches a limit, as it does not if work relief is tolerated.[9]

How full should employment be?

The question of how full should employment be is even more troublesome. If unemployment is wasteful, surely this waste should be held to a minimum. Some such waste, indeed, is unavoidable: some minimum unemployment is a necessary cost because attempts to eliminate it would themselves be wasteful

[7] 81st Congress, 1st Sess., Joint Committee on the Economic Report, *Hearings*, "Federal Expenditure and Revenue Policies," p. 9.

[8] Beveridge, *op. cit.*, p. 20.

[9] The conflict between relief and work relief became very explicit in the early days of the New Deal, with Harry Hopkins as the effective opponent of the dole and the advocate of make-work. See James A. Maxwell, *The Fiscal Impact of Federalism in the United States* (Cambridge, Harvard University Press, 1946), p. 149.

or dictatorial. Wartime achievement in reducing unemployment is a special case. At such a time an excess of aggregate demand is assured because more war goods are needed than can be obtained. But the combination of an insatiable demand for a limited type of goods, suppression of production of goods which compete for materials, and compulsion in allocating labor and capital does not exist in peacetime. Even if government then undertook to raise aggregate demand so as to eliminate unemployment, the problem would remain of what peacetime goods to provide and how much of each. Would the test be what the market wanted or what government felt people ought to have? Beveridge recognized this difficulty. He was *not* content to allow citizens to allocate peacetime outlay at their option because they might not direct it "to those forms of consumption which were socially most desirable." Government must concern itself with the *direction* of outlay, at least until all citizens are provided with a minimum of housing, health, education, and nutrition.[10] Beveridge faced up also to the issue of 100-percent employment. It would mean that no concern, private or public, could hire another worker unless it found other firms ready and willing to "release a workman who was qualified for this work and either was living in the right place or was willing to move to it."[11] In a dynamic society this would, he declared, be stifling.

Beveridge's definition of full employment

Beveridge wanted, nonetheless, to keep the total of necessary unemployment to a minimum, and he therefore defined full employment as "having always more vacant jobs than unemployed men." Translated into a figure, this meant for Great Britain unemployment of not more than 3 percent of the civilian employees in the labor force.[12] To many critics this raised the old issues in attenuated guise. To them 3 percent unemployment was so low as to be inflationary and a threat to essential citizen

[10] Beveridge, *op. cit.*, pp. 185-87.

[11] *Ibid.*, p. 125.

[12] *Ibid.*, pp. 18, 127-28. Seasonal unemployment would make up 1 percent, unemployment incidental to progress 1 percent, with another 1 percent growing out of Britain's dependence upon international trade. "If Britain were a closed economic system, it would be reasonable to take as an objective the reduction of unemployment to 2 per cent."

liberties. Beveridge denied these threats, but it should be noticed that he did not count as important the maintenance of private enterprise. On the contrary, if the goal of full employment, as defined by him, required abolition of private property, then "this abolition would have to be undertaken."[13] Indeed, the suspicion is that Beveridge knew that his figure, if accepted, would bring either socialism or governmental control over the location of industry, over labor mobility, over investment, and over prices and wages.

The bias in the Beveridge figure was asserted by many economists in the United States where supporters of full employment were less content to march toward socialism. Gottfried Haberler declared the Beveridge percentage to be "incompatible with a free enterprise economy."[14] J. M. Clark, writing in 1944, said that normal peacetime unemployment of 3-4 million (approximately 5-7 percent of the then civilian labor force) would give "a really high level of employment," while Alvin Hansen declared for 3 million (about 5 percent) and Sumner Slichter for 3-5 million.[15] Sir Douglas Copland, a little later, declared for 5-8 percent.[16] The dangers feared by these men, all favorable to use of fiscal policy to maintain high employment, were inflation and much more detailed regulation than is consistent with free enterprise.

The fear of inflation was, of course, evidence of the change in opinion brought by the war. Joan Robinson, writing in 1938, called inflation "a stock bogey" used to frighten the public. "In time of peace with a stable government and a competent mone-

[13] *Ibid.*, p. 23.

[14] G. Haberler, "The Economic Systems of the Democracies and Totalitarian States," *Proceedings of the American Academy of Political Science*, Vol. XXII, p. 309.

[15] P. T. Homan and F. Machlup (eds.), *Financing American Prosperity* (New York, Twentieth Century Fund, 1945), pp. 116, 307, 396. The Hansen figure is deduced from his national income computations.

[16] Douglas Copland, *The Road to High Employment* (Cambridge, Harvard University Press, 1945), p. 70. He used the report of the National Resources Planning Board, *Security, Work and Relief Policies*, 78th Congress, 1st Sess., House Document No. 128, Part 3, p. 132. The report, written in 1941, cited the opinion of experts for 5-8 per cent. In a footnote it quoted "optimistic estimates" to the effect that we could not expect "to achieve more than 92 to 95 percent of full employment." The shift in opinion brought by the war is very evident.

tary authority it is little to be feared."[17] Such confidence could not be expressed today. In the immediate postwar years neither government nor monetary authority opposed the inflationary pressures generated by powerful trade unions and a complaisant employer attitude. Beveridge, to his credit, foresaw that in peacetime, with patriotic restraints removed, industrial discipline might be impaired and a spiral of wages and prices become chronic. As remedies he suggested: (1) that labor should bargain on a national rather than a sectional basis, so that a unified and responsible wage policy might be achieved which looked "not to the snatching of short sectional advantages, but to the permanent good of the community;"[18] and (2) that there be greater recourse to arbitration. The frailty of these props is obvious. Why should it be assumed that a national body, speaking for labor, would resist pressures by specific labor groups? It is, moreover, always possible to argue with plausibility that wage demands need not be inflationary—that they can be absorbed by profits and productivity.

Beveridge, conscious that his remedies might fail, faced with equanimity the prospect that, as a result, industry would be socialized and wage determination would become a job for government.[19] What then? Would all conflicts disappear? Would socialization of industry, with substitution of discipline through government decision for discipline by the market, resolve the problems? Would the process require loss of citizen liberties?

[17] Joan Robinson, *Introduction to the Theory of Employment* (London, Macmillan & Sons, Ltd., 1938), pp. 120-21.

[18] Beveridge, *op. cit.*, pp. 23, 194-201.

[19] "If trade unions under full employment press wage claims unreasonably, maintenance of a stable price level will become impossible; wage determination will perforce become a function of the State. If the private owners of business undertakings under full employment set out to exploit consumers by organizing monopolies and price rings, or abuse their economic power for political purposes, or fail, with all the help of the State, and in an expanding economy, to stabilize the process of investment, the private owners cannot for long be left in their ownership. If the people of Britain generally under full employment become undisciplined in industry, that will show either that they are not sufficiently civilized to be led by anything but fear of unemployment and are unworthy of freedom, or that the control of industry must be changed. All liberties have their responsibilities. The greater the sense of citizen responsibility, the greater can be the measure of liberty and the scope that is left for agencies independent of the State." Beveridge, *op. cit.*, p. 207.

3. PROPOSAL OF UNITED NATIONS COMMITTEE

Proposal of a full employment target

The idea that full employment should be defined with precision has recently been advanced by a distinguished group of economists who stated:

> We believe that the first requirement for a successful full employment policy is that governments establish a full employment target that will provide a guide-post for their policy. This target should be expressed in terms of percentages of wage-earners out of work and seeking work; with proper allowance for the full time equivalent of the hours of work lost by persons who are working on short time but who are willing and able to work full time.

The target should be "the smallest percentage of unemployment of wage-earners which the country in question can reasonably hope to maintain in the light of seasonal movements and in the light of structural changes in the economy, which inevitably give rise to some temporary unemployment that could not be eliminated through public policy."[20] A range of from 2 to 4 percent or from 3 to 5 percent of wage earners was suggested, instead of a precise figure. While some variation from country to country was to be expected, the group felt that "in the light of recent experience, the target in most countries can be set in terms of a much smaller percentage of unemployment than was regarded as normal before the war." Uncertainty over the intentions of governments was "a major factor making for economic instability." If government policies could become known, private business decisions would show a more stable pattern.[21]

Little fear of inflation

The group endorsed automatic devices to deal with unemployment in excess of the target, but it did *not* regard them as appropriate for dealing with inflation. If a choice should arise between inflation and a loss in employment, the former would

[20] Report by a Group of Experts (J. M. Clark, Arthur Smithies, Nicholas Kaldor, Pierre Uri, E. Ronald Walker) appointed by the Secretary-General, *National and International Measures for Full Employment,* United Nations, Department of Economic Affairs (New York, 1949), pp. 15, 74.

[21] *Ibid.,* pp. 42, 74.

be chosen. No dislike of selective controls is shown and the group can fairly be charged with a preference for suppressed over open inflation. In view of postwar experience this is surprising. As Professor Viner put it:

> That after all the experience and the debate of the past decade the preference for suppressed over open inflation can be so blandly presented without argument, without any discussion of the comparative evils of open inflation, on the one hand, and, on the other hand, of the absenteeism, the unpenalized inefficiencies, the padded personnel in plants, the upgrading for pricing and downgrading for quality and service, the queues, the bottlenecks, the misdirection of resources, the armies of controllers and regulators and inspectors, associated with suppressed inflation, is to say the least surprising, as is the failure to balance degrees of unemployment cured thereby against the costs of curing them.[22]

The reason may lie in the fact that the report was written in the last quarter of 1949 when many observers felt that the postwar inflation was over and that, once again, *the problem* was unemployment.

Responses of member nations

The Economic and Social Council of the United Nations, acting upon the advice of the group, asked member countries to define a target of unemployment. The replies, published in 1951, were mostly noncommittal, but not that of the U.S.S.R. It declared: "There is no unemployment in the Union of Soviet Socialist Republics, and full employment of the population is assured."[23] Canada argued that a quantitative employment standard might lead to overemphasis of one objective to the detriment of other goals—higher standards of living and economic stability are mentioned. It argued further that, for the complex Canadian economy, rigid and oversimplified concepts were unsuitable in shaping policy.[24] The United States also felt that no definite and

[22] Viner, "Full Employment at Whatever Cost," *Quarterly Journal of Economics* (August 1950), p. 391.

[23] *Problems of Unemployment and Inflation, op. cit.*, p. 145.

[24] *Ibid.*, pp. 35-36. Another objection, different in type, was that jurisdiction over many matters concerning labor lies in the hands of the provincial governments.

Sweden and Denmark, like Canada, were against rigid definition. Italy was unable to set a norm or adopt a full-employment policy because its unemployment was of a long-run structural character (p. 9). Belgium defined full employment as unemployment of 2.9 percent of the total civilian labor

unalterable goal should be set. For each year after 1946 the President had announced employment goals of 96-97 percent of the civilian labor force. The appropriate figure should be higher in a year of partial mobilization than for a peacetime year when 3.6 percent of the civilian labor force might be regarded as a minimum level of unemployment.

4. TECHNICAL PROBLEMS OF FULL EMPLOYMENT

Technical difficulties of defining unemployment

Apart from constitutional uncertainty and bureaucratic bias toward noncommittal answers, what explains the unwillingness of many countries to set a target of unemployment? Part of the answer lies in certain technical problems of definition. The Bureau of the Census, which gathers data concerning the labor force by personal interview, defines an employed person as (a) at work or (b) with a job but not at work because temporarily absent. The unemployed are those not at work and looking for work (except for satisfactory reasons). The figures of the employed have been criticized as too high because they include some persons who have temporarily been laid off; those of the unemployed as too low because they include some part-time workers. A labor economist declared that for August 1949 the estimate of unemployment by the Bureau of the Census should have been 5,325,000 instead of 3,689,000.[25] A strong defense of the practices of the Bureau can be offered, but the fact is that there is no accepted and unequivocal definition. If an official target were set, interested parties could and would press for computation to suit their purposes. And if government, having set a normal range of unemployment, felt bound to keep actual unemployment within the range, pressure groups would feel that the wraps were off. When, as now, they are uncertain as to the extent

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force or 3.7 percent of the labor force available for hire. Great Britain defined its standard as 3 percent of the total number of employees, equivalent to 2.75 percent of the total civilian labor force. It alone had *adopted* a specific full employment standard.

[25] Russ Nixon, "Correction of Census Bureau Estimates of Unemployment," *Review of Economics and Statistics* (February 1950), p. 54. In 1954 Senator Douglas and Representative Bolling declared that the Census method underestimated unemployment. 83d Congress, 2d Sess., Joint Committee on the January 1954 Economic Report, House *Report* No. 1256, p. 23.

of the commitment of the government, restraint seems prudent.

Another technical problem grows out of definition of the labor force so as to include employables and exclude unemployables. Persons under a certain age, persons in institutions, etc., are *not* employables, but inevitably marginal workers—unreliable, inefficient, neurotic—are included, and many of them will be unemployed even in good times.

Structural unemployment

But the most important problem in setting a satisfactory target arises because unemployment is not all of a piece; some types do not yield readily to an increase in aggregate demand. So it is with seasonal, and also frictional, unemployment. What of structural unemployment arising out of market imperfections—some prices, some wages, too high? In a dynamic economy methods, products, and industries are constantly shifting, and unemployment is an inevitable by-product. The United Nations group argued that (a) the amount of this unemployment was minor and (b) it would be reduced by an adequate effective demand. "This was proved," it declared, "by British experience during the war, when large so-called 'structural' unemployment, which had previously been attributed mainly to lack of mobility of labour, melted away, leaving an acute labour shortage."[26] But surely this *proof* is unacceptable and its citation reveals a vital danger of the approach to full employment via aggregate demand. A very high aggregate demand can pull unemployment, no matter of what type, down to very low levels. In wartime Britain it fell to ½ of 1 percent of the labor force, and in the United States almost as low, through use of the war techniques of direct controls *plus* suppressed inflation. It is clear that we get overemployment, and the costs associated with it, before unemployment is eliminated. The appropriate issue is: Suppose effective demand is carried only to where employment would be full without inflation, how much unemployment would there be?

Structural change impeded by full employment

Use of aggregate demand to reduce the total of structural unemployment is surely costly. The ills suffered now by the

[26] *National and International Measures for Full Employment, op. cit.*, p. 13.

cotton textile industry in Rhode Island and Lancashire, by the linen industry of Northern Ireland (or one hundred and thirty years ago by the handloom weavers) cannot be remedied efficiently either by supporting employment in these areas or by subjecting the whole economy to inflation.[27] Rather is it true that structural change, when it can be identified, should be carried through quickly and boldly. Yet this is seldom done because (a) identification is not easy and (b) palliatives are readily at hand. While it is now clear, after three decades, that the trend of employment in the cotton textile industry here and in Great Britain has been irrevocably down, when could this have been identified? Looking backward, the record of what was done, as well as what was left undone, may seem incredibly bad. Has it not, in parallel cases, always been so? The record of our society through the decades shows strong resistance to innovations in production and to the structural adjustments which follow. As John Jewkes has said, vested interests, easy-going optimism, political escapism will

> justify doing nothing or doing precisely the wrong things. In an industry confronted with real structural changes the employer will be inclined to argue that if wages can be reduced a little all will be well, the wage earner that if the employer were only a little more efficient all would be well, the statesman that if both will work a little harder all will be well.[28]

Most readers will be able to illustrate these generalizations.

Structural unemployment by itself defies measurement. But when technological innovations, especially labor-saving, come slowly and steadily it will be smaller than in the opposite case.

[27] In December 1951 when the rate of unemployment was 1.4 percent for Great Britain as a whole, it was 8.5 percent for Northern Ireland. In April 1952 when it was 2.2 percent for Great Britain, it was 10 percent for Northern Ireland. D. T. Jack, "Full Employment in Retrospect," *Economic Journal* (December 1952), p. 738.

Insured unemployment in Rhode Island was 7.88 percent of the insured labor force 1947-1952, while for the United States it was 3.94 percent. In November 1948 when unemployment nationally was under 3 percent of the civilian labor force, nine labor-market areas showed unemployment of 7-11.9 percent and one of 12 percent and over. Report of the Joint Committee on the January 1954 Economic Report, *op. cit.*, pp. 88-89.

[28] "Second Thoughts on the British White Paper on Employment Policy," *Economic Research and the Development of Economic Science and Public Policy* (New York, National Bureau of Economic Research, 1946), p. 120.

"Slacks" and a dynamic society

It may be that our system of enterprise requires "slacks" in order to be dynamic, and generates "slacks" because it is dynamic. Technological changes and changes in demand make it necessary that some industries grow while others decline, that firms rise and fall, that labor be mobile. A surplus of resources is "continuously being reabsorbed through expansion of output but recreated through further advances in productivity."[29] Over the decades this system has been remarkably efficient and the irregularity of employment which comes with it is, within limits, to be accepted as a necessary cost and not as "waste."[30]

Costs of overfull employment

It may also be that the costs of overfull employment, always disguised, are now more visible than in the days when it had seldom been experienced. Queues of people seeking employment were a characteristic of Great Britain in the 1930's; consumer queues and shoddy goods were a characteristic of the 1940's.[31] Neither belong to the good society.

5. THREAT TO FREE ENTERPRISE AND DEMOCRACY

The economic dangers of overfull employment set the stage for political and social consequences of vast significance. If an ambitious target is set and if it becomes the unequivocal function of government to implement this target, the free-enterprise system and democracy itself might be endangered. Some proponents of a high target (Beveridge is cited above as an example) are content to sacrifice free enterprise and move to socialism while denying the threat to democracy. At the other range of opinion are many

[29] John H. Williams in *Financing American Prosperity*, p. 353.

[30] In the United Nations report, *National and International Measures for Full Employment, op. cit.*, J. M. Clark notes that the United States owes it to the world to narrow these limits. "In terms of fluctuations, the United States might be inclined to accept a moderate amount of irregularity, and rely on its social security system to provide for the resulting unemployment. But the impact of our fluctuations on other countries will not allow us as good citizens of an interdependent world, to decide the question in the same terms that might govern us if we were isolated." (P. 103.)

[31] H. C. Booker, "Have We a Full Employment Policy?" *Economica* (1947-1948), p. 38.

liberal European economists, especially Germans, who are fearful even of fiscal policy and are convinced that to adopt full employment as a goal would be to take a long step toward a centrally controlled economy and dictatorship.[32] Neither of these positions is accepted in these pages. Rather is it assumed that fiscal policy will buttress, and not impair, free enterprise and democracy. But fiscal policy may be distorted; pursuit of a goal of overfull employment may lead to socialism, and socialism may endanger democracy. The preservation of democracy may well require the existence of a substantial field for the exercise of private economic power.[33] Even if this is not so—even if socialism, full employment, and democracy are compatible—the case for free enterprise over socialism is assumed here.[34]

[32] See Walter Eucken, *This Unsuccessful Age* (New York, Oxford University Press, 1952). The latter group draw upon the experience of the 1930's; the former, attuned to the defects of capitalism, urge socialism as the perfect society.

[33] This is argued eloquently by Robert M. MacIver, *Democracy and the Economic Challenge* (New York, A. A. Knopf, 1952).

[34] Keynes has a succinct paragraph in the *General Theory* in which the advantages of "individualism" (connoting the free-enterprise system) are strongly put. The advantages are partly those of "efficiency." In his words: "The advantage to efficiency of the decentralization of decisions and of individual responsibility is even greater, perhaps, than the nineteenth century supposed; and the reaction against the appeal to self-interest may have gone too far." He goes on to claim that individualism safeguards personal liberty and variety of life. "But, above all, individualism, if it can be purged of its defects and its abuses, is the best safeguard of personal liberty in the sense that, compared with any other system, it greatly widens the field for the exercise of personal choice." *General Theory of Employment, Interest and Money* (New York, Harcourt, Brace & Co., 1936), p. 380.

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The Council of Economic Advisers

> Does a study of the case history here recorded lead to the conclusion that the philosophy expressed and the machinery set up in the Employment Act mark a logical evolution from the institutions and the traditions of our past, soundly adapted to the changing conditions of our present and outlook for the future? Or is it already apparent that this was a brave try against impossible odds or even an ill-conceived venture and that, on either judgment, it should be abandoned, writing this off as merely an episode in the history of a free people constantly experimenting with new ways to better the common lot?—EDWIN G. NOURSE.[1]

1. INTRODUCTION

In many countries the issues discussed in the preceding chapter were publicly debated before the end of World War II, and legislation was enacted committing the governments to maintenance of high employment. So it was in the United States where the Council of Economic Advisers was created in the Executive branch and a Joint Committee in the Congress to carry out the purposes of the Employment Act of 1946. This measure as enacted differed considerably from the bill from which it originated.

Full employment not defined

A so-called Full Employment bill (S. 380) was introduced on January 22, 1945, by Senator James E. Murray. The drafters of the bill, according to its historian, thought of the title as "a polit-

[1] Edwin G. Nourse, *Economics in the Public Service* (New York, Harcourt, Brace & Co., 1953), pp. 450-51.

ical device";[2] they did not mean by full employment even employment as high as had Sir William Beveridge. In an early draft a definition of the amount of admissible unemployment had specified that it should be "no greater than the need to preserve adequate flexibility in the economy," recognizing that allowance should be made for "frictional unemployment, including seasonal and technological unemployment."[3]

Original technique to secure it

Much more important, however, was the technique to be used to maintain full employment, however defined. At the beginning of each regular session the President was to transmit to Congress a National Budget setting forth, for the next fiscal year, an estimate of the aggregate volume of expenditure from all sources required to provide employment opportunities for the estimated labor force. The estimated aggregate volume of prospective expenditure might fall short of what was necessary to assure "a full employment volume of production." When such a prospective deficiency in the National Budget was forecast, the President was to set forth a program for encouraging nonfederal expenditure to prevent the deficiency. But if this was believed to be insufficient to bridge the gap, the President was to "transmit a general program for such Federal investment and expenditure as will be sufficient to bring the aggregate volume of investment and expenditure by private business, consumers, State and local government, and the Federal Government, up to the level required to assure a full employment volume of production."[4]

Deletion of this technique by Congress

The striking requirement was that the President estimate in January of every year what the National Budget as an aggregate and in broad detail should be for a year ending eighteen months later, and that he recommend a legislative program based on this forecast. John H. Williams has commented as follows:

> I think there can be no doubt that, if the bill had been approved in this form, its principal effect, despite the professions of some of

[2] S. K. Bailey, *Congress Makes A Law* (New York, Columbia University Press, 1950), p. 49.

[3] *Ibid.*, p. 50.

[4] 79th Congress, 1st Sess., S. 380, Sec. 3 (c).

> its advocates, including Senator Murray, to the contrary, would have been to commit us, as fully as the most enthusiastic supporters of compensatory fiscal policy could have wished, to a policy of offsetting fluctuations in private investment and consumption by Federal budgetary changes.[5]

This provision, interpreted by opponents to be a federal *guarantee* of full employment, was removed during the legislative process, and in its place the President was merely required to transmit an Economic Report, setting forth current levels of employment, production, and purchasing power, and their foreseeable trends.

Another important legislative change was the de-emphasis of the technique of federal *spending*. In the original bill it had been the major countercyclical device. By a curious process of political bargaining a substitute declared

> that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power.[6]

Spending is not mentioned. It is, however, possible to interpret the declaration of federal responsibility "to use all practical means . . . to promote maximum employment, production and purchasing power" as stronger than a commitment to deficit spending. Thus, Edwin G. Nourse holds "the view that there is more political and economic dynamite in the phrase that was finally accepted than in the one which was rejected."[7] On the other hand, Senator Taft has interpreted the act merely to say "in effect that the Government shall take thought and shall

[5] 80th Congress, 1st Sess., Joint Committee on the Economic Report, *Hearings*, Part 1, p. 201.

[6] Public Law 304, Sec. 2.

[7] Nourse, *op. cit.*, p. 342.

provide the machinery for eliminating economic depression."[8] And this position is like that of John H. Williams who has stated:

> As I interpret, the Employment Act of 1946 as finally approved, it carries no hard and fast committment to any specific type of policy and at the same time does not bar out any type of policy, including compensatory fiscal policy. . . . As it now stands, the act represents a great step forward. While refraining from outrunning our present knowledge in the application of economic analysis and technique to governmental policy, it recognizes fully the concern of the Government for the national economic welfare and provides machinery and a procedure for dealing with it.[9]

Jacob Viner has given an even more limited interpretation. "It would," he feels, "be a mistake to read too much into the declaration of policy as marking a change of economic philosophy." The declaration was a substitute for a much more specific pledge and the act should not be interpreted as if it contained *excluded* material.[10] History so far may seem to support this interpretation, but so far Congress has not been forced by depression to reveal its economic philosophy. The act was conceived and passed with depression in mind and with no real attention to the dangers of inflation, and the measure as passed deleted references to inflation contained both in the Senate bill and the House bill.

Yet with all its vagueness, the Employment Act does show that Congress in 1946 accepted the responsibility thrust upon it during the 1930's of taking *positive* action to maintain economic stability, a responsibility hitherto deduced only from the general welfare clause in the Constitution. The federal government is, moreover, to secure the assistance of state and local governments, and of agriculture, industry, and labor, in providing "conditions under which there will be afforded useful employment opportunities.[11]

[8] *Ibid.*, p. 344.

[9] 80th Congress, 1st Sess., Joint Committee on the Economic Report, *Hearings*, Part 1, p. 202.

[10] "The Employment Act of 1946 in Operation," *Review of Economic Statistics* (May 1947), pp. 76-77.

[11] This last phrase in Section 2 has been interpreted by the Council of Economic Advisers to rule out "leaf raking or digging holes and filling them up." First Annual Report (December 1946), p. 4.

2. THE COUNCIL OF ECONOMIC ADVISERS

Establishment of a CEA and Joint Congressional Committee

The act set up two new pieces of governmental machinery. (1) A Council of Economic Advisers (CEA) of three men was to be appointed by the President, by and with the advice of the Senate, to assist and advise the President in preparing an Economic Report which was to be sent to the Congress within sixty days after the opening of each regular session. The report was to set forth the current employment situation, trends in employment, production and purchasing power, and a program to implement the act. The CEA itself was to make an annual report to the President each December. (2) A Joint Committee of Congress on the Economic Report was also set up, consisting of seven members of the Senate and seven of the House. This committee was to study and appraise the Economic Report and to pass on to Congress by May 1 (originally February 1) its findings concerning "each of the main recommendations made by the President in the Economic Report."[12]

Economic Report of the President

An Economic Report of the President and a report by the Council to the President were presented twice a year mid-1947 through January 1953. In mid-1948 the Economic Report was shortened by omission of an economic and statistical analysis. This material was shifted to the Council Report which, thereafter, was bound in with the Economic Report and transmitted with it to the Congress. The change in practice was the occasion for a sharp rift within the CEA. The chairman, Edwin G. Nourse,[13] felt that the new practice would reveal "differences between our conclusions and the President's policy decisions," but his two colleagues (Leon Keyserling and John D. Clark) and the White House overruled him. As it turned out Nourse soon felt compelled to resign and the issue became academic when the CEA, under the new chairmanship of Keyserling, engaged not only in economic interpretation, but also in outright support of

[12] Public Law 304, Sec. 5(b) (3).
[13] Nourse, *op. cit.*, p. 217.

every position taken by the President. No mid-year reports were presented in 1953, and in January 1954 the Council made no *public* report.

Internal dissension

The CEA in its first three years was bedeviled by internal dissension, White House indifference, and Congressional harassment. Possibly this is the inevitable fate of economics in the public service at the policy level, and certainly the occasions for internal dissension do not reveal the heart of the matter. On one occasion, as has been mentioned, the quarrel arose over the form of the reports. But the trouble lay deeper. Two members, Keyserling and Clark, did not fear a conflict between their views and those of the President because they were prepared to accept his views; Nourse felt that as an economist he might differ, and yet somehow be allowed *publicly* to express this in an official report. Of course, this is impossible. The CEA was not, and should not have expected to be allowed to put anything in its public report which was contrary to any policy of the Executive branch. Such public expression of a technical economic opinion cannot be tolerated. In practice the CEA reports, circulated in advance among the different federal agencies, were always "cleaned up," toned down, written ambiguously.[14] Nourse's fear that somehow separation of the Economic Report and the Council report would reveal differences of opinion had little foundation. The two were almost certain to be in conformity. The conclusion indicated is that no *public* report by the Council should be made, and this has been accepted by the Council as reconstituted in 1953.

A related occasion of bickering within the CEA concerned testimony before Congressional committees. Here also Nourse, objecting to testimony, split with his colleagues; on appeal to the White House, testimony was allowed.[15] Undoubtedly testi-

[14] Keyserling was sure that the Council "could always phrase our analysis and recommendations in such a way that there would not appear to be any conflict between our views and those of the President." Nourse, *op. cit.*, p. 217. During the *Hearings* before the so-called Patman Subcommittee on General Credit Control and Debt Management, Senator Douglas accused Keyserling of getting himself and his questioners lost in a "semantic wilderness."

[15] Nourse, *op. cit.*, p. 222. The act itself was ambiguous on this issue. *Ibid.*, pp. 407-12.

mony by a federal official will sometimes make it impossible for him to render a technical economic judgment. And the economist in the public service cannot, when before a Congressional committee, take refuge in evasion or silence. As Nourse put it:

> If a Council member responds to a request of a Congressional committee to appear as a witness on matters covered in the Economic Report of the President or on topics under investigation or review before standing or special committees, "the lead is in their hand." The committee can choose the area of questioning, phrase their interrogations, inject their comments, and suggest inferences in ways which will relentlessly draw out from the Council member any divergences or reservations that he may have as to the economic wisdom of policies advanced by the President or other branches of the Administration.[16]

An economist not in the government service is, of course, not so handicapped. He *can* give a technical opinion. His pitfalls in testimony concerning policy are lack of appreciation of political considerations and, sometimes, lack of responsibility.

White House indifference

White House indifference to the CEA was a sore spot with the first chairman. He sensed as early as the fall of 1946 that President Truman was not interested in the work or conclusions of the Council and, as time passed, that the Council was valued "only as a dignified front" for Presidential policies.[17] Whether this judgment is too harsh and whether other Presidents may be more attentive, only history will disclose.

Congressional harassment

Congressional harassment of the Council centered in the House Appropriations Committee which cut the appropriation request for fiscal year 1947 from $400,000 to $350,000, and to $300,000 for each of the fiscal years 1948-1952. For fiscal 1953 Congress gave an appropriation of $225,000 to last until March 31 when a new Congress and President were to reappraise what should be done. The reasons for this hostility were various and not quite consistent: Some Congressmen blamed the CEA for Executive policies they disliked, while others blamed it for taking academic

[16] *Ibid.*, p. 403.
[17] *Ibid.*, p. 370. See also p. 137.

positions. In 1953 a new Congress, taking its lead from the House Appropriations Committee, refused to appropriate any money to carry the CEA through the last quarter of fiscal year 1953; instead it made $50,000 available to the White House, and this forced the Council to wind up its affairs.

Reorganization in 1953

The Hoover Commission had in 1949 recommended that the Council "be replaced by an Office of the Economic Adviser and that it have a single head," because as a multiheaded body the CEA had suffered from public disagreement among its members.[18] The Commission felt, moreover, that the Council, like the Office of the Budget, "should not take public leadership on issues of policy in its own right." President Eisenhower chose, however, to continue with a Council. In March 1953 he appointed Arthur F. Burns as his Economic Adviser and then in June sent to the Congress a plan for reorganization of the Council which was permitted to go into effect on August 1.

> To strengthen the internal administration of the Council, the responsibility for employing staff, specialists, and consultants was transferred from the Council to the Chairman. To establish a clearer relationship with the President, the function of reporting to the President on the Council's views and activities was likewise transferred to the Chairman. The position of Vice Chairman of the Council was abolished.

The aim was to centralize responsibility while retaining "the advantage of the balanced judgment that several individuals could bring to bear on economic problems."[19]

Need for reform

Some reform in organization and effort was essential. Nourse has avowed that, during his tenure, the work of the Council "fell apart into somewhat unrelated guerilla operations in response to the particular and sometimes temporary interests of single Council members and strong individuals within the staff.[20] For

[18] Commission on Organization of the Executive Branch of the Government, *General Management of the Executive Branch* (Washington, 1949), pp. 16-17.

[19] *Economic Report of the President* (January 1954), Appendix A, pp. 120-21. Arthur F. Burns was designated Chairman. The two other members are Neil H. Jacoby and Walter W. Stewart.

[20] Nourse, *op. cit.*, p. 420.

whatever reason the first CEA spread itself too thin and failed to concentrate on the major issue of economic stabilization. In terms of Congressional intent, the members of the Council should have been economic stabilization advisers and the Economic Report should have been "the stabilization-of-the-economy report."[21] Yet from the very beginning the Economic Report contained many recommendations concerning long-run economic objectives—indeed, many more than for the short-range program. Discrimination in employment and wages, the school-lunch program, regional development, encouragement of small business, antitrust action, programs of public health, nutrition, and education, old age and survivors insurance, formation of the International Trade Organization, stabilizing public works construction according to long-term needs—all of these and more were mentioned. Such issues, whatever their importance, are not countercyclical. Congress has debated many of them for decades, and it will continue to debate them. And about these multifarious proposals the CEA could never speak with special authority. To endorse them—or to have the President endorse them in a Report written by the CEA—without any appraisal of their cost and relative importance, was careless. The real job of the CEA was stabilization—a program to maintain high level economic activity by moderating cyclical swings.[22] Undoubtedly the language of the act was so loose as to give warrant for other activities, but living memory testified that the intent was to do something to avoid, or moderate, economic depression, with incidental attention to inflation. As the majority of the Joint Committee of the 80th Congress said: "This task is sufficiently difficult, and we do not think that work under the act should be diverted from it by the study of all the important and complicated problems of social welfare, health, and education, nor should it be diverted

21 *Ibid.*, p. 422-23.

22 Alvin Hansen writing in May 1947 about the first Report asked: "Was not the Economic Report supposed to do something more than reiterate the legislative program of the Administration? Was it not supposed to come to grips, in plain English, with slumps, depressions, unemployment?" He went on to argue that the Report was "*not* the place to urge general social security legislation, for example. It *is* the place to make a *specific* recommendation with respect to the financing of social security if the President and his advisers believe that current financing methods reduce employment." *Review of Economic Statistics* (May 1947), p. 73.

to matters which cannot have an extensive effect on the over-all economy."[23]

In its first report to the President the CEA gave, indirectly, a justification for its all-over-the-map approach. It criticized what it dubbed "the Roman doctrine" of an external remedy—that the economy as a whole "may be kept on a reasonably even keel merely through the intervention of central government in the monetary and fiscal area." It would, the Council continued, "be very simple indeed if we could rely on fiscal policy as a panacea"; but why limit ourselves "to a single remedy—and a crude one at that—when we can muster a set of remedies fitted to the whole range of particular situations?"[24] For those enamored with fiscal policy as a panacea, this is sound advice, but surely they were few. And the vital complaint is that the CEA never mustered the "set of remedies" or analyzed "particular situations." The Economic Report continued annually to repeat the whole economic program of the administration; the report of the Council, especially after 1949, gave broad interpretative discussions of very many aspects of current economic phenomena.[25]

In the process of implementing its broad aims, the CEA went up several blind alleys. Section 2 of the Employment Act mentioned that the federal government should secure "the assistance and cooperation of industry, agriculture, labor, and State and local governments," and section 4(e) spoke of advisory committees from these same groups. The CEA thought that such consultative functions would be "one of the major features" of its work. It hoped somehow that, by exchange of opinion and dissemination of knowledge, labor and management might be led to pursue a wise social policy, leaving government with merely a complementary role.[26] In the first Economic Report great emphasis was

[23] 80th Congress, 2d Sess., Senate Report No. 1358, p. 2.

[24] CEA, *First Annual Report* (December 1946), pp. 12-14.

[25] The *Economic Report* of January 1953 listed prevention of depressions as one of *three* purposes of the Employment Act of 1946. The other two were better economic policy coordination "within the Congress and the Executive Branch, and also between private enterprise and all levels of government," and "the positive resolution of a great people, not simply to avoid pitfalls, but also to maintain as a matter of continuing policy a full, bountiful, and growing economy. . . ." (Pp. 9-10.) This last "purpose" is mere *blague*, while the second should be a by-product of the first.

[26] CEA, *First Annual Report* (December 1946), pp. 16, 21.

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put upon voluntary price reduction, and in the second Report there was the same stress on the responsibility of management and labor to act in the short run so as to serve their long-run interests. "Economic stabilization can be achieved within our private enterprise system only if management accepts the responsibility for a more stable practice in planning its investment and operative programs."[27] The reason was that, otherwise, the swings would be too big for government to compensate. This very approach tended to minimize what government could do, with no enlargement of its functions. The philosophy of Leon Keyserling, who became chairman in late 1949, was also damaging to study of fiscal policy devices. For him the key word always was "production."[28] If inflation was to be checked, the right way was through more production. Other weapons—fiscal policy and monetary policy—were inferior, and this at a time when the economy had more than full employment and was producing at record levels. In such a situation industry might, perhaps, feel that it faced the task of Sisyphus. If it succeeded in raising production, government would respond by reopening the inflationary gap. Indeed, in its early days, the CEA was taken aback by the persistence of inflation. Slowly it came to fear inflation, but it always thought that deflation was just around the corner. If further handicaps to anti-inflationary recommendations were needed, they were provided by a concern for equity and "an addiction to consumer-purchasing power economics."[29]

The charge of timidity in the use of fiscal policy can be substantiated most notably by examining the Economic Reports of 1948 and 1949. In the former the President recommended "a cost-of-living tax credit of $40 for each taxpayer and each dependent. To offset this decrease in government revenues, cor-

[27] CEA, *Second Annual Report* (December 1947), p. 18.

[28] This is the characterization given by Herbert Stein, "Monetary Policy and the Management of the Public Debt," *American Economic Review*, December 1952, p. 872.

[29] George Terborgh, *Review of Economics and Statistics* (1949), p. 177. Senator Douglas in 1952 jibed as follows: "The attitude of the Council of Economic Advisers toward a big Government deficit reminds one indeed of Mr. Dooley's comment about Theodore Roosevelt's attitude toward the trusts: 'On the one hand, I am against the trusts. On the other hand, not so fast.'" 82d Congress, 2d Sess., Joint Committee on the Economic Report, Senate *Report* No. 1295, p. 18.

porate taxes were to be increased sufficiently to yield an equivalent amount."[30] Possibly the deterrent effect on investment of the higher corporation taxes might offset the inflationary effect of the addition to the disposable incomes of individual taxpayers. But relief for income taxpayers would not help those who paid no individual income tax—perhaps one fifth of the population; indeed, their lot would be worsened, since their disposable incomes would shrink relative to those who secured the tax credit. In January 1949, still fearing inflation (erroneously), the Report recommended new taxation to raise $4 billion, mostly by additional corporate taxes, but also by higher taxes on estates and gifts. On the other hand, OASI benefits were to be increased substantially, the minimum wage was to be lifted from 40 cents to at least 75 cents an hour, public assistance and the housing programs were to be expanded. Undoubtedly such higher taxes would have had little effect in reducing consumption and a large effect in reducing saving (although not necessarily investment); expansion of OASI and the lifting of minimum wages would have stimulated pressure on consumption. In short, the recommendations were hardly consistent with a serious fear of inflation.[31]

3. JOINT COMMITTEE ON THE ECONOMIC REPORT

The Joint Committee had been instructed as one of its duties to report to Congress on the Economic Report. Its first report, made in May 1948, covered both the January 1947 and 1948 Economic Reports. Since the 80th Congress was Republican, the majority report was signed by the Republican members with Senator Taft as Chairman. It felt that the Economic Reports and the reports made by the CEA to the President had made "a good start on the national economic policy guided by more information and study than we have ever had before."[32] Criticism was directed chiefly at the broad scope of the Economic Reports to the detriment of the major problem of economic stabilization—

[30] *Economic Report of the President* (January 1948), p. 48.

[31] A criticism of earlier Reports as indifferent to inflation is given by F. W. Fetter, "The Economic Reports of the President and the Problem of Inflation," *Quarterly Journal of Economics* (1949), pp. 273-81.

[32] 80th Congress, 2d Sess., Senate *Report* No. 1358, p. 1.

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a theme repeated by the Republicans after they became the minority. In this first report separate minority views were appended, a practice to be followed frequently in later years. A reader finds reflected there the standard party arguments on economic policy, sometimes phrased moderately and sometimes not. The Democrats generally, and usually indiscriminately, endorsed the Economic Report, and Senator O'Mahoney, when Chairman of the Joint Committee, marshaled the CEA for public testimony in defense of the economic program of the President.[33] The Republicans, especially when in the minority, sniped at details in the Economic Report, disputing the claims of the President to wisdom in policy.

Hearings and techniques of the Joint Committee

The Joint Committee, in fulfilling its duty of reporting on the recommendations of the Economic Report, held hearings at which it listened to much testimony from experts not in government service. The hearings covered not only the Economic Report, but also such fields as investment, steel price increases, low incomes, monetary, credit and fiscal policies, monetary policy, and management of the public debt. The staff of the Joint Committee, moreover, prepared (or had prepared) a wide-ranging list of studies designed to keep the Committee abreast of current economic developments.[34] The staff also made and presented an independent appraisal of the economic situation, using bold projection techniques.[35]

33 In 1952, however, the Democratic majority criticized some portions of the Economic Report. In particular it rejected the tax recommendations as unrealistic and advocated a reduction in expenditures. Senator Douglas (along with Senator Benton) issued supplemental views which were quite explicit concerning reductions in expenditure. 82d Congress, 2d Sess., Senate *Report* No. 1295.

34 The conference which prepared the statement on "Federal Expenditure and Revenue Policy for Economic Stability" is one example. A second conference of twenty-three economists developed a statement "Monetary Policy to Combat Inflation."

35 The CEA used similar techniques, but never made its figures public to the disappointment of students who felt that material used as a basis for policy recommendations should be disclosed. The original version of the Employment Act *required* submission of projections, as well as a specific spending program based on them. A reason—perhaps the reason—why the projections of the Joint Committee have been made public is that an attempt to make them confidential would surely fail. The choice had, therefore, to be between no projections and projections publicly announced.

The Joint Committee on the Economic Report serves the Congress strictly in an advisory capacity; it has no power to initiate legislation. The Employment Act states that it is (1) "to make a continuing *study* of matters relating to the Economic Report," (2) "to *study* means of coordinating programs," (3) to be "a *guide* to the several committees of the Congress dealing with legislation relating to the Economic Report."[36] Since the Joint Committee can only study and advise the substantive committees, the effect it secures will depend significantly upon the merits of its economic analysis. How broadly should this analysis be extended? Senator Flanders, who has been a member of the Joint Committee from the beginning (and is now Vice-chairman), once stated that the Committee should analyze all the principal pieces of legislation which have "important economic implications" and report its findings to the substantive committees.[37] It may be questioned that this is wise. The Joint Committee (and the CEA) should focus on economic stabilization. This problem, while it cuts across many phases of policy, is still distinct; it is, moreover, likely to escape examination by the substantive committees. The Ways and Means and Finance Committees, for example, when considering social security legislation are unlikely to probe into the implications for fiscal policy. The Joint Committee might, however, appraise the legislation solely to discover if it could, or could not, be shaped so as to promote stabilization. So also with grant-in-aid legislation, tax legislation, agricultural price supports, etc. In such efforts the problem of avoiding conflict with, and charges of trespass from, the members of the substantive committees would be present. But it would be less delicate or acute if the Joint Committee limited its aim to, and, by the same token, strengthened its ability to make, a stabilization analysis.

4. *CONCLUSION*

Is the act inflationary?

In the seven years after 1946 the Employment Act did not face the test of depression. Full employment ruled except for a brief

[36] Public Law 304, Sec. 5(b). Italics supplied.

[37] "Administering the Employment Act—the First Year," *Public Administration Review* (1947), p. 226.

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and mild respite 1949-1950, and the major trend has been inflationary. Neither the Executive nor Congress will be as disturbed by inflation as by deflation. Excellent excuses for inaction have been at hand: postwar readjustment, the cold war, Korea. A pessimistic observer may conclude that excuses for neglecting moderate inflation will always be available and that overfull employment will never be a worry for the CEA or the Joint Committee. In 1952, indeed, the Patman Subcommittee put the blame for this neglect upon the Employment Act of 1946 rather than on the CEA. It said that the act gave "an overemphasis on the maintenance of high-level employment and an underemphasis on the maintenance of price-stability."[38] Perhaps this is so, but the likelihood that amendment will change the bias is slight.

When the Employment Act was passed, the notion was prevalent not only that, through it, the economic work of the Congress might be integrated, but also that something might be done to coordinate the Executive and the Legislature. Success, so far, cannot be claimed, but lessons can be learned and a new start made.[39] The purpose uppermost in every mind when the Employment Act was framed—economic stabilization and especially moderation of depression—should be re-established as the dominant goal.

[38] 82d Congress, 2d Sess., Joint Committee on the Economic Report, Subcommittee on General Credit Control and Debt Management, *Report,* p. 41.

[39] The Joint Committee has, I think, recorded a better performance than the CEA. The Douglas and the Patman Subcommittees helped resolve a dangerous conflict between the Treasury and the Federal Reserve system, and they provided excellent material for study in the area of monetary policy.

7

Timing of Fiscal Policy

> Economic forecasting is a notoriously hazardous enterprise, and political forecasting is perhaps even more risky.—WESLEY C. MITCHELL.[1]

> The State is not "a something not ourselves making for righteousness," but bald-headed gentlemen in offices, with strong class prejudices, an inclination to magnify their own authority, and a comprehensive ignorance of the lives of nine-tenths of those over whom it is exercised.—GEORGE UNWIN.[2]

1. INTRODUCTION

Defects of timing in prosperity

Many of the objections to the Full Employment bill of 1945 were objections to the idea of "full" employment rather than to fiscal policy. Thus the President of the National Association of Manufacturers, Ira Mosher, while opposing the original bill, recognized that "depression unemployment, as distinct from frictional unemployment," was a responsibility of the federal government "because such depression unemployment is a problem which is national in scope."[3] But *some* of the objections to "full" employment apply to fiscal policy as well, and some are unanswerable by economic argument. One such charge is that, during

1 Wesley C. Mitchell, *The Backward Art of Spending Money* (New York, McGraw-Hill Book Co., 1937), p. 123.

2 *Studies in Economic History: The Collected Papers of George Unwin* (London, Macmillan & Co., Ltd., 1927), p. lxix.

3 79th Congress, 1st Sess., House *Hearings* on the Full Employment Act of 1945, p. 574.

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the *upswing*, the restraining power of government, whether by fiscal or monetary policy, will always be used too late, if at all, because in our society very many people cannot distinguish between prosperity and boom. The outcome, therefore, is creeping inflation. This *may* be our institutional bias, and the economist, advocating fiscal and monetary policy, can argue simply that workable controls are available, although a precise knowledge of their force has not been gained. He can, besides, take the position that modest inflation is a cost which society is prepared to tolerate, that the great social losses of the business cycle come from depression, and that mass unemployment is a cost that a free-enterprise system cannot tolerate.

Defects of timing in recession

What defects of timing are attributable to the operation of fiscal policy in the *downswing*? Some economists argue that fiscal policy action then will be so prompt as to come before the mistakes of the prior boom are liquidated and to delay "sound recovery." But others hold lightly the danger of overprompt action in recession. They detect a lag between recognition of the need for action and actual action because of institutional and political obstacles to quick decisions by Congress. Appropriation and revenue bills in a democracy take time to prepare and enact. There may also be a lag between action and results, although fiscal policy, because it operates directly on the stream of national income, is likely in this respect to be superior to monetary policy. The *real* danger is that action may be delayed too long, and, as safeguards, some economists favor a revenue-expenditure system which has a high built-in flexibility so that, without new Congressional action, revenues will fall off and expenditures expand automatically with the onset of recession. They argue further that automatic signals are required which will empower the Executive to reduce tax rates and make new expenditures.

While a detailed appraisal of these issues will be given subsequently, the focus in this chapter is forecasting. Can fiscal policy be operated adequately—at least in recession—*after* the fact, or do we need to forecast when recession impends and to act, on the basis of this forecast, to forestall it? This was the philosophy of the Full Employment Act as originally introduced. Behind it

are two premises: (1) that accurate forecasts can be made, and (2) that prompt remedial action should be taken because the forces of recession, if unchecked, tend to gather cumulative weight.

2. *HOW GOOD IS FORECASTING?*

Forecasts in 1929

Forecasting, as a professional technique, had an amazing growth after World War I, and some forecasts of the depression of 1920-1921, as well as of minor recessions in the 1920's, were accurate enough to establish the confidence of the forecasters and their clients. In the spring of 1929 a distinguished group of business men and economists declared: "Our situation is fortunate, our momentum is remarkable."[4] When, late in the year, depression struck, this confidence, for a time, persisted. A leading economic service wrote in November 1929:

> A severe depression like that of 1920-1921 is outside the range of probability. We are not facing protracted liquidation of huge industries, world-wide demoralization in commodity markets, and rising money rates. Something more than a mild recession, such as that which occurred in 1927, is already certain. Since depressions, mild or severe, have not—so far as the record goes—occurred when commercial credits are generally sound and money is easing, precedent indicates a severe recession lasting a few months longer and followed by recovery.[5]

Late in December 1929, at a joint meeting of the American Statistical Association and the American Economic Association, the top forecasters differed only as to how soon the upturn would come, none placing it farther ahead than eleven months. Several times in the next three years the forecasters thought they detected turning points; prosperity was just around the corner. The memory of the disillusionment is still green. The forces of recovery petered out, and, as depression deepened, a sorry defini-

[4] Report of the Committee on Recent Economic Changes, *Recent Economic Changes in the United States* (New York, McGraw-Hill Book Co., 1929), p. xxii. Wesley C. Mitchell in his *Review* was much more cautious (pp. 909-10).

[5] 79th Congress, 1st Sess., House *Hearings* on the Full Employment Act of 1945, pp. 64-67. This, and a number of other forecasts, are cited.

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tion went the rounds: An optimist is a fellow who ignores what happened last time and what will happen next time.

In 1937

After 1932 a halting recovery began, although by mid-1936 there were still 8-10 million unemployed. In the spring of 1937 depression struck again, catching nearly everyone by surprise.[6]

In 1945

Unemployment vanished with World War II and the vast growth of government demand. But what of postwar, and especially the *transition* from war to peace?[7] When economists, using the new aggregative techniques, began to compute the growth in private consumption and investment necessary to offset the drop in military spending, they became convinced that such a growth could not be predicated and that, if heavy transitional unemployment was to be avoided, a large program of compensatory spending was essential. Harold D. Smith, the Director of the Budget, pressed by a House committee for an estimate of unemployment for 1946, stated in a letter of October 8, 1945:

> We obtain an estimated peak of unemployment of 8,000,000 which may occur early in the calendar year 1946. That is an increase of 6,000,000 over the level of unemployment in early September. It is further estimated that the progress of reconversion may reduce unemployment considerably during the calendar year 1946, although substantial unemployment would continue to exist.[8]

Other Washington forecasts were even more pessimistic, stressing not only the immediate primary impact of decreased military spending, but further derived effects on the levels of income and employment. These have since been dissected by Michael Sapir, who finds that for fiscal 1946 (a year after V-J day) the forecasts underestimated GNP by 10 percent, consumption expenditure by 13 per cent, and disposable income by 11 percent. The total

[6] In July 1936 the Board of Governors of the Federal Reserve had upped reserve requirements by 50 percent and in May 1937 by another 50 percent.

[7] Both political parties stated boldly that success would be achieved. The Democratic platform in 1944 promised "to speed victory, establish and maintain peace, guarantee full employment and provide prosperity." The Republican platform said: "We shall promote the fullest stable employment through private enterprise."

[8] 79th Congress, 1st Sess., House *Hearings* on the Full Employment Act of 1945, p. 104.

labor force (including the armed forces) was overstated by 4 percent and the civilian labor force by 6 percent. Unemployment as a residual (labor force minus employment) was overestimated by 4 million, an error of 186 percent. "From a policy standpoint," he concluded, "the estimated of unemployment is critical, since so many types of action hinge on its actual or expected size. Yet it is the magnitude we are least able to forecast (or even estimate!) with reasonable accuracy."[9] The post-mortem was the more gloomy because economists, enamored with the new aggregative techniques, had been confident that this time their forecasts were sound, and because Congress, exposed to the forecasts, was disillusioned with the failure.[10]

In 1947

In the next few years some economists were haunted by the fear that the rapid reconversion and continuance of high employment were miracles and that, once the backlog of demand was satisfied, recession would develop. On July 16, 1947, Leon Henderson and Richard V. Gilbert testified to the Joint Committee on the Economic Report about "the danger of a repetition of the collapse which in 1920 and 1921 followed World War I."[11] The

[9] "Review of Economic Forecasts for the Transition Period," *Studies in Income and Wealth* (New York, National Bureau of Economic Research, 1949), Vol. II, p. 282.

[10] While a compensatory spending program was not presented to the Congress, other economic policies of the Administration were based on the forecast. See A. G. Hart, "National Budgets and National Policy: A Rejoinder," *American Economic Review* (September 1946), p. 636.

Leo Barnes states that "by and large, private forecasting was even more wide of the mark than was public forecasting." His attention is devoted mostly to the CED forecast which, he claims, was right for entirely wrong reasons. "How Sound Were Private Postwar Forecasts." *Journal of Political Economy* (April 1948), p. 161.

[11] 80th Congress, 1st Sess., Joint Committee on the Economic Report, *Hearings on Current Price Development and the Problem of Economic Stabilization,* Part 1, p. 479. Paul A. Porter and Robert R. Nathan accompanied them, but did not testify. The group represented the Executive Committee of the Americans for Democratic Action. The position was summed up as follows (p. 490):

"The Chairman [Senator Taft]. Mr. Henderson, taking the whole effect of your paper, I take it you are predicting a serious recession . . . unless there is a substantial change in public policy, changes (sic) not likely to occur in the next 6 months.

"Mr. Henderson. Yes; that is correct."

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forecast rested upon a decline in current consumption, evidenced mostly by a fall in the physical volume of retail sales. For the time being this decline was being more than offset by a high level of business investment in plant and equipment, and in machinery, as well as by expansion of exports. But the level of investment was believed to be "highly abnormal," with indications that it would decline by the end of the year. When this happened, we would be precipitated "into a sharp recession of business activity."[12]

Senator Taft questioned the forecast, especially that investment would decline because of a dependence on consumption. At the very least, we would not know that investment was going to decline "until it begins to happen."[13] He went on to argue that an orderly decline in prices could occur with no danger to the economy. "Some recession may be a good thing, but I do not want it to go down so fast it becomes dangerous."[14]

Here, then, was another forecast by competent economists which was wrong. If the policy recommendations based on it had been accepted—raising the per-capita exemption for the income tax from $500 to $700, repeal of $2 billion of excises, a wage increase of 15 cents an hour, extension of unemployment insurance

[12] *Ibid.*, pp. 484, 492.

[13] "The Chairman (interposing). Your conclusion is that private corporation capital formation is going to decrease?

"Mr. Gilbert. Yes, sir.

"The Chairman. That is a threat to economy?

"Mr. Gilbert. That is right. And for the basic reason that business does not expand its capacity unless it has the assurance that there is a market for its production.

"The Chairman. I think it was a mistake of the New Deal from the beginning that consumer purchasing power is the solution. I think it is increased production.

"Mr. Gilbert. Do not misunderstand our position. Our position is that what is required is the proper balance between business spending and consumer spending. Our position is they must expand together; that business spending will not continue for any length of time if they do not. It is a fact that the two are moving in opposite directions; that is the basis of our concern.

"The Chairman. The money is being spent, and you do not think it will go on being spent.

"Mr. Henderson. That is right.

"The Chairman. I suggest that is the case. We do not know about it until it begins to happen." *Ibid.*, p. 495.

[14] *Ibid.*, p. 500.

with higher benefits, etc.—the surge of inflation which plagued the nation until the fall of 1948 would have been stronger.[15]

In 1948

In the late fall of 1948 a recession did develop, unforeseen by the CEA. The Economic Report of January 1949 was concerned about inflation. "It is essential to sound fiscal policy," the Report declared, "to have a budget surplus now. This is our most effective weapon against inflation." The President recommended new taxation to raise $4 billion.[16] Thus the first time during the life of the CEA that a turning-point was encountered, it passed undetected.

This survey of failures is not made with the intent of displaying "shoddy wisdom after the event,"[17] or to decry forecasting. The lesson is simply that, at present, forecasting techniques give unreliable results and should not, therefore, be used as the foundation for fiscal policy. Forecasting should be continued with every effort to improve it. But positive action by reduced tax rates or increased appropriations should wait until events show us where we are. In short, such fiscal policy should be brought into operation after, and not before, a turning-point.[18]

3. APPRAISAL OF OBJECTIONS TO DELAY IN FISCAL POLICY

Unreliability of forecasts

This is a frustrating conclusion. According to Leon Keyserling it disregards

> the supreme lesson of the last great depression—that it is easier to retain prosperity with mild measures than to regain a lost prosperity

[15] The consumer price index was 156 in May 1947 and 174.5 in September 1948.

[16] *Economic Report of the President* (January 1949), p. 10. The Report of the CEA itself stated that "stabilization policy for the immediate future is still concerned mainly with restraining inflationary forces." (P. 74.)

[17] T. Wilson, "The January 1949 Economic Report of the President," *Review of Economics and Statistics* (1949), p. 168.

[18] Forecasts of sectors of business activity can be made with considerable accuracy by ascertaining business plans. Levels of activity can also be forecast roughly by projections of the recent past. Forecasts of turning-points, so far, have been quite unsuccessful.

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> with heroic measures. Those in the area of economic policy who do not acknowledge this are as far behind the times as those physicians who remain unaware that the early detection and prevention of disease now weighs more heavily in the scales of the nation's health than surgery or the treatment of epidemics.[19]

The analogy is intriguing, and if an economic forecast could detect with certainty an incipient recession before it had developed, then remedial steps should be taken. But the evidence is not only that the diagnosis is unreliable, but that, for this reason, the prescription may bring on ills not originally present.

Power of fiscal policy unknown

Another difficulty is with the economic measures which may be recommended to offset a boom or a slump. The policy maker who wants to know what effects they will have must be satisfied with less than certainty.[20] What *is* expansionary and contractionary can be stated with considerable assurance, but the power of the measures cannot because (a) reckoning of multiplier and acceleration effects must be guesses and (b) the causes of the particular boom or slump will be known only to a limited extent. Despite this limited knowledge it is reasonable to suppose that antideflationary measures, if put into effect (as they would be according to the Keyserling thesis) when full utilization of resources prevailed, might have *explosive* inflationary effects *unless* the expected recessionary forces actually developed. If antideflationary measures are put into effect *after* a recession is underway, the danger indeed remains that the recession may reverse itself and restore inflation with the measures serving as contributors. But this is a modest risk which must be taken.

Uncertainty in timing

Congress, as a democratic body, will respond more readily to use of fiscal policy against deflation than against inflation. This

[19] "The Economic Test: Will We Act in Time?" *New York Times Magazine* (June 13, 1948), p. 7.

[20] J. K. Galbraith argues persuasively that fiscal measures are more predictable than monetary measures, but that direct measures—price fixing and rationing—are still more predictable. "Problems of Timing and Administering Fiscal Policy in Prosperity and Depression," *Proceedings of the American Economic Association* (May 1948), p. 443.

bias would be much more dangerous in the event that anticipatory policy became the rule. It might well mean use of anti-deflationary measures in time of boom so as to ward off an expected recession, but failure to enact anti-inflationary measures at *any* time.

This fear should not, however, be exaggerated because it is in the nature of the Congress to be deliberate. Such deliberateness, whatever its defects, offers some protection against hasty action and special pleaders; it serves to screen the innumerable and urgent requests for action made to the Congress. It has also the converse effect of stimulating those making the requests to greater efforts, especially by dramatizing their appeal. During and after World War II dramatic appeals were numerous and, quite frequently, they forced Congress to capitulate. Congress resented these pressures from the Executive branch and it cherished memories of false crises.[21] Because of this background, Congress may be suspicious of forecasts of recession; it may prefer to act after the event rather than before.

Bad announcement effects

Another difficulty of anticipatory action lies in announcement effects. Indeed, so long as Congress keeps in its own hands full discretion with respect to fiscal policy, it is fatuous to urge that action be based upon forecasts. An economist in the Executive

[21] During the Hearings on the Full Employment Act of 1945 Representative Manasco made the following remarks (79th Congress, 1st Sess., *Hearings*, p. 65): ". . . I believe it was in April of this year, or maybe in March, that we had experts from the War and Navy Departments, the War Production Board, and other Government agencies, coming before the Military Affairs Committee and saying that unless we passed a labor draft bill we would probably lose the war. That was debated fully and freely on the floor of the House; and in less than 3 weeks' time the people who came up requesting the passage of the legislation appeared before a Senate committee and said that we did not need it. . . . And another case we had was the nurses draft bill. Thousands and thousands of boys were going to die unless we drafted nurses. Of course, when you try to lay the life of some boy at our doorstep, we start to squirm. In less than 3 weeks' time the same thing happened in that case.

"You can go back to our food production. There was the prediction that we would have plenty of meat after surveys had been made by all the agencies the Government had. Some people did not have any meat, and I am getting some letters still saying that they do not have any lard, bacon, and things like that down in my part of the country now."

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branch who, as a technician, believed that a recession was imminent, would not be permitted—even if he wished—to make such a forecast. The political reasons for this restraint, while obvious, are buttressed by other reasons. The forecast, as public knowledge—and it could not be kept secret if made to a Congressional committee—might bring about the very recession which was predicted.

A standard answer to this difficulty is that business will be reassured rather than frightened because the forecast will be accompanied by the promise of preventive governmental action. In the present state of public knowledge of fiscal policy, this answer is unconvincing. It is reasonable to assume that, after recession is a fact, business confidence will be strengthened by the intervention of government to compensate for the decline. But until a longer and more successful history of fiscal policy is behind us, an official forecast of recession may be expected to impair business confidence more than an official assurance of compensatory action will support it.[22]

4. PRICE-COST RELATIONS AND TIMING

The origin of depression is to be found not simply in a deficiency of aggregate demand, but also in maladjustments of prices, costs, and profits. In prosperity some profits are too high and some too low, in relation to costs; retained earnings may be uninvested. Oligopoly, administered prices, restrictive practices create imbalances which depression serves to rectify by the brutal operation of unemployment and capital losses. Avoidance of the maladjustments would, of course, be a better solution. In a free-enterprise system the rising profits which grow out of increasing productivity and new investment should be passed on by lower prices and higher wages. How to do this "in a steady and orderly manner which business can tolerate without deflationary setbacks

[22] If the Full Employment bill of 1945 had been passed as introduced with the requirement that the government forecast any prospective deficiency in aggregate demand and recommend a spending program to bridge the gap, the fear of bad announcement effects might have induced caution in forecasting a gap. Strong espousal of this point of view would lead to the judgment that the bill was less dangerous than opponents declared.

or the impairment of investment is the central problem."[23] Investment should be made to function as a cost reducer and not simply as a device for pump priming.

Fiscal policy not a remedy for bad price-cost relations

Fiscal policy does little or nothing along these lines. Indeed, if business and labor unions became convinced that fiscal policy could be completely effective, so that government would make up for capital losses and unemployment, then the pressure to remedy structural defects would be diminished. At best fiscal policy is designed chiefly to combat the results of economic maladjustments rather than the causes.

Would not a direct attack on causes be more fruitful? As a long-run policy, it would surely be desirable to strengthen the free-enterprise system "as an evolving institution with increasing community responsibilities." One step, as J. M. Clark has suggested, would be for government to reconsider "the burdens, controls, etc. now laid on business (laid mostly without regard to their effect on its capacity to furnish ample employment) to decide which may be substantial handicaps and which of these may be removed without losing more than we would gain."[24] Another step would be to search for answers to the question of what is the optimum relation between prices and costs, both for maintenance of economic stability and securing rapid economic progress.

But this does not mean that the right road to economic stabilization is by correction of structural maladjustments. In the first place, our knowledge of what they are comes only after considerable delay and is certain to be in dispute. In the second place, the *direction* in which to move is, in the short run, quite uncertain. The issue of wage-price relations will supply an illustration. Surely it is reasonable to assume that some relation between wage rates and prices is optimum for economic stability. But it is not now possible to say whether, in the face of recession, an increase or a decrease of wage rates, relative to prices, would add

[23] J. H. Williams in *Financing American Prosperity*, P. T. Homan and F. Machlup, eds. (New York, Twentieth Century Fund, 1945), p. 372.

[24] 79th Congress, 1st Sess., Senate *Hearings* on the Full Employment Act of 1945, p. 1029.

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to aggregate demand. Those favoring an increase in wage rates argue that income is thereby shifted from profits, unlikely to be invested, to wages, certain to be spent. Aggregate spending will, therefore, rise, and through maintenance of consumption the outlook for investment will be improved. But the assumption that investment depends on consumption is dubious, and a very different chain of events may develop, arising from the fact that wages are a cost as well as a source of consumer spending. On the other hand, reasoning about a decrease of wage rates is also slippery. By reducing costs, especially in sectors where costs and prices are relatively high, the effects would be stimulating. But if the demand for labor were inelastic, the fall in aggregate wages might push the economy downhill.

Structural adjustments do have a relevance for fiscal policy. Use of fiscal policy to add to aggregate demand early in recession may prolong the maladjustments and create an economic structure which, in the long run, cannot be maintained. Used after some delay, the force of fiscal policy may be reinforced by the operation of corrective tendencies stemming from the recession.[25]

The right short-run tactic may be, therefore, to let price-cost-profit relations be determined without governmental intervention and to rely for economic stabilization on use (with a lag) of fiscal and monetary policy.[26]

[25] J. M. Clark, after giving some hypothetical examples of maladjustments, concludes: "These examples are intended to illustrate that the wage-price structure, while it may neither bring on great mass-unemployment nor cure it, can place obstacles in the way of a successful outcome. With an unfavourable structure, it may be impossible to set as high an unemployment target as with a favourable structure, or may be possible only at the cost of price inflation, or an increase in the real burden of public debt, or both. Improvements in the structure may be necessary for attaining a fully satisfactory employment target; and in countries attaching importance to voluntary methods, this may take time." United Nations, Department of Economic Affairs, *National and International Measures for Full Employment* (New York, 1949), pp. 102-3.

[26] This is, I believe, the advice given by sixteen economists in "Federal Expenditure and Revenue Policies," although their statement uses guarded language. "When the economy is prosperous and stable and there is no *clear-cut* reason to expect a change," the budget should be marginally balanced. "However, if recent *events* and the *outlook* for the near future *pointed,* on balance, toward unemployment," then deficits are prescribed. "On the other hand, if the *weight* of the evidence appeared to be on the inflationary side," surpluses are proper. In discussion of *acute* recession, the statement

It cannot, however, be denied that delay brings problems and dangers of its own. How long should positive compensatory action be withheld? How great a fall (rise) in income and employment is to be tolerated before fiscal policy is put into operation? If recession (inflation) takes hold, may it not gain cumulative force, so that the job of fiscal policy will become more difficult? No certain answer to these questions can be given. Greater reliance than at present upon built-in flexibility to protect the economy automatically against both slumps and inflation does seem indicated. By this technique resistances develop both to rise and fall of income and employment; time is gained which may enable government to discover what positive action should be taken. And during this respite improvements in the price-cost-profit structure may develop. In default of assured answers as to when to intervene, it may be that arbitrary standards to initiate fiscal policy action should be defined, e.g., unemployment of x percent, a price-rise of x percent within a specified period, warrant positive action. In the case of growing unemployment, it may be guessed that a decision to act will be determined by social and political opinion even if no standards are set up.

The idea that recession, if allowed to run, may grow into depression, cannot be proved or disproved by examination of the record. The great depression after 1929 appears to support it, but before the nadir, minor upturns—abortive so it proved—appeared in 1930 and 1931, which, if nourished by a strong fiscal policy, might have brought recovery. The course of events then, as usually, was so complex that certainty in analysis is not possible. In lesser depressions—1921, 1938, 1949—recovery was rapid without the assistance of positive fiscal policy. Indeed, in 1938 the fiscal policy was probably perverse. At best, there is a choice of risks. The risk preferred by the argument outlined here is that fiscal policy be employed tardily, but with vigor. By this tactic utilization will not outrun present knowledge of its effects.

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speaks of "a definite expectation, justified by *events*"; but action to halt "serious inflation is advised when it is "in *prospect*." The italics, all of which are supplied, indicate a leaning toward *ex post* but an unwillingness to forego *ex ante* action. (81st Congress, 1st Sess., Joint Committee on the Economic Report, *Hearings*, pp. 447-48.)

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8

Variation of Expenditure and Revenue, Especially Through Built-in Flexibility

> Though automatic stabilizers cannot provide adequate correctives for fluctuations in economic activity, they are extremely valuable tools for dealing with such fluctuations. For, by augmenting income and stimulating demand on the downswing and by removing that stimulus on the upswing, they dampen the magnitude of economic fluctuations and thus reduce the size of the problem with which other measures must deal.—EVERETT E. HAGEN.[1]

1. INTRODUCTION

Reasons have been offered why annual balance of the budget is both impossible and undesirable and why deficits are helpful in depression and surpluses in prosperity. Should a positive effort, then, be made in depression to increase expenditure and to reduce revenue? In prosperity should the effort be to reduce spending and raise taxes? At first sight it might seem that both types of action would require legislative action. The main theme of this chapter is, however, that deficits in depression and surpluses in prosperity can be achieved *automatically*. With no change in tax rates, receipts from the present federal revenue system will swell and decline with each increase and decrease in GNP, and more than proportionally. Federal expenditures exhibit the opposite

[1] Everett E. Hagen, *Proceedings of the American Economic Association* (May 1948), p. 420.

tendency, although in less degree; that is, they will expand with a fall in GNP and shrink with a rise. These revenue and expenditure variations are "built-in." May it be that the deficits and surpluses so engendered would be sufficiently effective so that exercise of Congressional discretion, by enactment of new legislation, would be unnecessary?

CED plan

The Committee for Economic Development (CED) has offered a plan of this sort which it calls a "stabilizing budget policy." Its essence is stated as follows:

> Set tax rates to balance the budget and provide a surplus for debt retirement at an agreed high level of employment and national income. Having set these rates, leave them alone unless there is some major change in national policy or condition of national life.[2]

Three factors require determination: (1) the appropriate level of tax rates, (2) the agreed high level of employment and national income, (3) the amount of the surplus. The third of these is put arbitrarily at a figure of $3 billion *more or less;* it would bring about a rate of debt retirement seldom achieved in our history. The second raises questions appraised earlier in the discussion of the meaning of full employment. As stated by the CED, a dual test for a standard or base year is offered: employment *and* national income. The latter, because it is set in value terms, would have to be recomputed quite frequently in a dynamic economy to allow for changes in productivity, price level, etc. An employment standard would require less frequent recomputation, since it would not be affected by price changes. The two standards might diverge. For example, an *orderly* fall in the price level might bring a fall in national income without any fall in employment; a stable value index might fail to signal a substantial decrease in employment. A value index may seem appropriate if the object of fiscal policy is to signal both inflation and deflation, and it would tend also to preserve budget symmetry over the business cycle. The employment standard is appealing in

[2] CED, *The Stabilizing Budget Policy, What It Is and How It Works* (New York, 1947), p. 8. More recently the CED has dropped the idea of achieving a surplus and aims merely at balance in the cash budget. "Taxes, National Security and Economic Growth," New York, 1954, pp. 11-12.

human terms. Assuming determination of an employment *or* an income standard, and the amount of the budget surplus, the appropriate level of taxes for a normal year of high employment and income would follow automatically.

What would happen to annual revenue and expenditure in the event of recession and boom, assuming no change in tax rates or in programs of expenditure? What is their built-in or automatic flexibility? The extent of the variation obviously depends not only upon the amplitude of cyclical swings, but also upon the nature of the revenue and expenditure system. Some taxes and some programs of expenditure have much greater flexibility than others.

2. *BUILT-IN FLEXIBILITY OF TAXES*

Variation in tax revenues depends upon (a) the tax base and (b) the rates. Both base and rates can, of course, be altered by the legislature, but built-in flexibility does not depend upon a change in legislative definition. It confines attention to shifts in the size of the base, and therefore in revenue, growing out of *change in economic conditions.*

Taxes differ in flexibility

In the family of existing taxes the poll tax has the least built-in flexibility, since its yield varies from prosperity to depression only as taxpayers default on their liability. The general property tax has low flexibility because property valuations for tax purposes are, in practice, quite insensitive. For this very reason a severe depression brings arrearages in tax payments as property owners become unable to pay tax assessments. The outcome in such a case is haphazard and incalculable flexibility. But in moderate depressions the yield of the property tax holds up, and in booms it grows only slightly. At the other extreme of flexibility is a capital gains tax with full deductibility of losses. In 1931 the federal tax on capital gains had a *negative* yield of $89 million, although in 1928 it yielded $576 million. As will appear more fully later, the federal corporation and individual income taxes have high flexibility; the chief excises only a modest flexibility.

Effect on disposable income

What is the economic effect of built-in tax flexibility? Taxes with *stable* yields bear heavily on taxpayers in depression and easily in boom. A taxpayer who has to pay the same amount of tax on a piece of property when his income from it has diminished, will be afflicted with a fall in disposable income which is more than proportionate. Forced to curtail his spending (and saving), he will reduce the incomes of other people. In boom, however, the taxpayer will pay the same tax even though his income from his property has grown. With a larger disposable income he may spend more and thus intensify the boom. The impact upon taxpayers of taxes with *flexible* yields is quite different. In depression the fall in tax liability provides taxpayers with some relief; in boom the rise induces some restraint.

Built-in flexibility greater when government revenue is large

If, now, attention is shifted from the taxpayer to the government, the effect of built-in flexibility of taxes is to give it a larger share of national income in boom and a smaller in depression. Assuming government expenditures remain the same, the result is a larger deficit in depression and a larger surplus in boom. In depression (boom) a part of the decline (rise) in private incomes is, so to speak, absorbed by the government. Suppose, as in Table 2, Case I, that total national income—the private and public together—falls from 300 in the Year 1 to 255 in the Year 2, i.e., by 45 (15 percent), and that government income falls from 75 to 60, i.e., by 15 (20 percent), then the fall in private income is from 225 to 195, i.e., by 30 (13.3 percent). The *share* of the decline borne by government is 33.3 percent. Is is worth noting also that the absorbing power of built-in flexibility is much greater when government revenues are relatively large than when they are small. If, as in Case II, government income in the Year 1 were 10 (and private 290), the same assumptions would bring a fall of 43 in private income. The *share* of the same absolute decline of 45 borne by government falls from 33.3 percent to 4.4 percent.[3]

[3] The Committee for Economic Development offers (*The Stabilizing Budget Policy, op. cit.*, p. 15) the following comparison of the comparative cushion

Table 2. HYPOTHETICAL VARIATIONS IN BUILT-IN FLEXIBILITY

	Year 1	*Year 2* (a)	*Year 2* (b)	*Decline or Increase*	
National income	*300*	*255*	*345*	*±45*	*15.0%*
I. Private	225	195	255	±30	13.3%
Government	75	60	90	±15	20.0%
II. Private	290	247	333	±43	14.8%
Government	10	8	12	± 2	20.0%
III. Private	225	225	225	0	0.0%
Government	75	30	120	±45	60.0%
IV. Private	225	180	270	±45	20.0%
Government	75	75	75	0	0.0%

The table illustrates also parallel cases of increase, rather than decline, of national income. Then, supposing government expenditure to remain unchanged, a surplus would result, absorbing part of the increase in income.

A simple formula for measurement of built-in flexibility is, therefore, $\frac{\Delta T}{\Delta Y}$, where ΔT and ΔY are, respectively, the change in government revenue and in national income. For Case I above, the value is .33; for Case II, .04. A formula to measure *elasticity* is $\frac{\Delta T}{T} \div \frac{\Delta Y}{Y}$ where T and Y are, respectively, government revenue and national income in the base year. The value of elasticity both in Case I and Case II is 1.33.

The *limits* of built-in flexibility with the above formula are unity and zero. If, as in Case III, the increase (decrease) of 45

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under private incomes provided by built-in flexibility in 1948-1949 compared with 1937-1938 and 1929-1930:

	4th qtr. 1948-4th qtr. 1949	*1937-1938*	*1929-1930*
Decline in Gross National Product	$13.5 bil.	$5.5 bil.	$13.0 bil.
Decline in government income	5.2 "	0.9 "	0.6 "
Percent of decline borne by government income	38%	16%	5%

While some part of the above result is attributable to a different *composition* of revenues, most of it stems from the greater relative importance of government finance in 1948-1949.

in national income is exactly equal to the increase (decrease) in government revenue, the value of built-in flexibility is 1. If, as in Case IV, the increase (decrease) in national income is accompanied by no increase (decrease) in government revenue, the value of built-in flexibility is zero.

In all of the four examples the assumption has been made that government expenditures remain unchanged with increase or decline in government revenue. In such case the potential deficit cannot exceed the amount of the expenditures. But if increase in government expenditures is presumed, the amount of the deficit is not constrained.

When measurement of *over-all* built-in flexibility is in question, it seems proper to take national income, or gross national product, as the base. But when particular taxes are being examined, it may seem appropriate to relate changes in tax yield to changes in the precise base upon which the tax is levied. In no case is this base as broad as national income. Thus the individual income tax is levied upon surtax net income which, currently, is only 40 percent of personal income and 36 percent of national income as reckoned by the Department of Commerce. The federal excises fall upon spending which is, as an aggregate, less than one quarter of total spending for consumption, and this latter total is about 75 percent of national income. The bases of other federal taxes are much narrower. The following dilemma is, therefore, posed: Accuracy of measurement and of prediction indicates that built-in flexibility should be related to the *actual* base of a particular tax; on the other hand, it is desirable that over-all built-in tax flexibility be calculated, and this cannot be achieved by summation of particular flexibilities when each base is different.

3. BUILT-IN AND ADMINISTRATIVE FLEXIBILITY OF EXPENDITURES

Discretionary spending not often countercyclical

It should be obvious that a very large amount of federal expenditure is *not* cycle-sensitive and should not be varied cyclically even by the exercise of Congressional discretion. This is true

notably of spending for national security, which, except for brief interludes, has been the dominant type of federal spending throughout our history. Defense expenditure has, of course, been highly variable, but the variation has been wholly unrelated to the business cycle. Defense, as Adam Smith observed, is more important than opulence, and Congress should not give or withhold appropriations for it with an eye to economic conditions. A decision to construct or not to construct a new aircraft carrier should not depend, even marginally, on the level of private construction. A decision to reduce the size of the armed forces should not be made with an eye on conditions of employment.

In the world of yesterday these generalizations seemed beyond dispute, but nowadays doubts spring to mind because of the prospect of semimobilization as a long-run condition. In a world which has neither peace nor war, economic appraisals of inflation and deflation, though not decisive, become relevant in appraising even expenditure for national security.

The influence of war expenditure in limiting the scope of fiscal policy extends beyond the actual period of war. This is so not only because of a large aftermath of expenditures (e.g., for veterans' benefits and interest), but also because in wartime normal provision of many peacetime goods, among them public works, is reduced. When the war is over, more public works will have to be supplied regardless of economic conditions. If, in the years after termination of war, unemployment prevails, then a larger outlay on public works will be doubly beneficial. But even in the opposite situation of high employment, some of the backlog will have to be made up. Considerations of fiscal policy will *not* be governing.

No detailed argument is needed to make the further point that expenditure for the routine, day-to-day peacetime functions is not cycle-sensitive. Regulative, judicial, legislative, administrative services are wanted and performed in a steady stream with, perhaps, some long-term trend upward.

If, then, the fact is accepted that a large slice of federal expenditure is of no use for fiscal policy, the government must fall back upon (a) legislative authorization in recession of new programs which are terminated with the return of prosperity, (b) full

exploitation of those few expenditure programs which do possess built-in and administrative flexibility.

Welfare spending sensitive only to depression

After 1932 the former of these alternatives was used. There was, at the discretion of Congress, a proliferation of new programs, some of which were liquidated after 1940. Some were retained, and it is to be expected that welfare programs, instituted in depression, will often become permanent because Congress decides that they are appropriate additions to the agenda of government of a wealthy and democratic nation. This tendency toward noncontractibility is one reason why conservatives may oppose introduction; it is why reduction of taxes may appeal as a better fiscal policy; and it explains the attractions of "wasteful" expenditures which have the virtue of becoming wholly unattractive as soon as "productive" employment is available.

Concept of built-in flexibility of expenditure imprecise

The other alternative—exploitation of programs with built-in and administrative flexibility—is promising, although the techniques are less precise for expenditures than for revenues because concepts parallel to "base," and "scale of rates" seldom exist. A strict definition of built-in flexibility of expenditures would embrace only those which respond without any new legislative action and without exercise of administrative discretion by the Executive branch. Since Congress prefers to provide *annual* appropriations for most programs, this appears to leave little room for built-in flexibility. But two cases *do* meet the test fairly well, and a third could be made to do so. The two are expenditure from the social insurance trust funds[4] and as agricultural price supports.

The sensitivity of expenditure for social insurance payments stems from variation in current human needs; it has a "natural" countercyclical basis. (See Chapter 10.) Increase in unemployment brings increase in payment of unemployment benefits and, to a less degree, of old age and survivors benefits. It should be noticed

[4] Expenditure from and receipts into the trust funds are not a part of the conventional budget, but they are of the so-called cash-consolidated budget which rests upon the concept of receipts from and payments to the public.

also that federal expenditures for public assistance, veterans readjustment benefits and pension payments will grow in recession (and shrink in boom) even though they are provided by annual appropriations. The amount of the appropriations depends upon the terms of the basic legislation; Congress has, in actual practice, little or no discretion.

The program of agricultural price supports rests upon acceptance by Congress of the view that depressions are "farm-bred and farm-fed," i.e., that agriculture is especially sensitive to the forces which generate depression and that it pulls the rest of the economy along with it. (See Chapter 9.) A depression fall in farm incomes should, therefore, be prevented, and this can be accomplished by a price-support program, operating chiefly by formula, because *production* of farm products is not price-sensitive in the short run.

The third case of built-in flexibility is public works. (See Chapter 11.) Expenditure on them can be made countercyclical by formula (or by discretion) because highways, dams, and public buildings are durable goods. Bought in lumps, they are consumed in a stream. But unless a *conscious* fiscal policy is followed, this expenditure will have the same pattern as private construction. History shows, indeed, that state and local expenditure for public works has been perverse, aggravating both booms and depressions. In the 1930's, however, the federal government pursued—imperfectly—a countercyclical policy.[5]

For a number of federal programs a good deal of expenditure flexibility can be secured by managerial and administrative decisions. Congress has set up business-type corporations, such as the Export-Import Bank, the Federal National Mortgage Association, the Federal Housing Administration, which operate with relative financial freedom in spending, lending, and guaranteeing. Their policies have a relation to economic conditions; relevant economic variables can be detected. In the recent past, indeed, these programs have often been cyclically perverse, but expansion and contraction could be made consistent with, and part of,

[5] The federal government had, indeed, shown some recognition of this policy after World War I, and Herbert Hoover, when Secretary of Commerce, was much impressed by its potential. *The Memoirs of Herbert Hoover, the Great Depression, 1929-1941* (New York, The Macmillan Co., 1951), p. 144.

a rational fiscal policy without significant departure from their direct objectives. Such performance would, however, not be built-in; it would require exercise of managerial discretion. But no Congressional legislation would be necessary to secure significant swings in expenditure. The Associate Director of the Budget, Roland R. Hughes, in February 1954 estimated that these public enterprises could quickly increase or decrease their annual rate of spending by $2 billion.[6]

There is, furthermore, a good deal of administrative or executive flexibility in the regular federal budget which, while not strictly built-in, can be made to operate almost as if it were. Congress gives obligational authority extending beyond a year to departments, especially the Department of Defense, to spend for construction and procurement programs. Actual spending is alterable at the discretion of the Executive, and decisions consistent with national security requirements will depend upon such factors as availability of labor and materials. Progress can be speeded up or slowed down by administrative decision. Even under annual appropriations this may be feasible, although speed-up might make it necessary to submit a request for supplemental appropriations.

Another area of administrative flexibility arises out of price declines. The Bureau of Budget when it finds that appropriations, on this account, are in excess of what is needed to buy a specified amount of goods and services, will place the excess in "budgetary reserves." These the President can release to speed up completion of projects and programs.

4. ESTIMATE OF CURRENT BUILT-IN FLEXIBILITY

Accurate identification of those federal expenditures which have positive built-in flexibility, and a reckoning of amount, are tasks which could be performed only by the Bureau of the Budget; they are beyond the knowledge and resources of the individual investigator. Crude guesses can, however, be offered to indicate approximate magnitudes. A recession fall of 15 percent in GNP (half in terms of a price fall) from a level of $360

[6] 83d Congress, 2d Sess., *Hearings* on the January 1954 Economic Report of the President, p. 33.

billion might bring, within a year and one half and with no *new* spending programs, a net rise of federal cash expenditures of $2.5-3 billion. If attention is concentrated only on programs which expand, a rise of $6.5-7.5 billion could be anticipated of which 33.33 percent would be attributable to unemployment compensation and OASI, 17 percent to the agricultural price-support program and other government corporations, and 40 percent to administrative flexibility.[7] But against this expansion must be set reductions in spending arising out of the fall of prices in recession. These would be important and prompt in reducing the dollar amounts spent for some types of military procurement.

With federal expenditure running at an annual rate of $70 billion, a net expansion of $2.5-3 billion may seem unimpressive. But it should be noticed (a) that this is built-in and does not allow for provision of new programs by Congress, (b) that this flexibility, as will be shown later, can be increased, and (c) that the absolute amount of the flexibility would remain about the same if the aggregate level of federal spending should decline because of a reduction of expenditure for national security.

Assuming a balanced budget and a GNP of $360 billion, a fall of 15 percent in GNP would also bring a decline of approximately $11 billion in revenues, distributed as follows:

	(in billions)
Direct taxes on individuals	$ 4.5
Direct taxes on corporations	4.0
Excises, customs, other	1.4
Receipts of trust funds	1.1
	$11.0

This, when added to an increase of $2.5 billion in expenditure, would give a cash deficit of $13.5 billion, a figure large enough to put some strain on current Congressional and public tolerance.[8]

[7] A considerable slice of the increase would be transfer payments. By them the government itself does not absorb output, but it makes the recipients able to do so. Transfer payments are often likened to taxes with a minus sign, and they have the advantages of taxes for fiscal policy.

[8] The deficit shown by the conventional budget would be smaller, since payments from and receipts to the social security trust funds are not shown in it. The cash surplus of $3 to $3.5 billion produced by the trust funds in good years would be reduced or even converted into a deficit. A. G. Hart has reck-

The built-in flexibility of state and local finances is very difficult even to guess. On the revenue side the flexibility would be much less than the federal because of the greater importance of consumption and property taxes. In 1950 state and local sales taxes and miscellaneous revenues were 5 percent of consumer spending. If the decline in consumer spending is 40 percent of a decline in GNP, then 2 percent of a decline in GNP would fall on these tax revenues. A fall of $54 billion (15 percent) in GNP would bring a fall of $1,080 million in sales tax receipts. Revenue from property taxes would also be inflexible. On the other hand, depression would greatly expand state and local expenditures, especially for general or direct relief (which receives no federal grants), and contract their expenditure for public works.

5. MERITS AND DEMERITS OF BUILT-IN FLEXIBILITY

The merits of built-in flexibility stem largely from its automatism. Stabilizing effects follow with no new legislative action and with no lag between the need for action and the effects of action. This is a comforting assurance because, under our system of government, Congress has difficulty both in making and acting upon an economic diagnosis. Difficulty in diagnosis of what is the condition of the economy has the defect that it allows inherent Congressional biases to operate. Congress, reflecting faithfully the bias of citizens, favors tax cuts over tax increases; it is therefore, slow to recognize inflation and sensitive to suggestions of lurking depression. Unwilling to increase taxes to curb a boom, it may listen to the opinion that the way to stop prosperity from sliding into slump is to cut taxes. As the CED has stated:

> The really frightening possibility is that we shall oscillate between adherence to the annual balance principle in prosperity and belief in compensatory spending in depression. This could only mean an endless ascent to higher and higher government spending, both in prosperity and depression.[9]

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oned, writing in 1953, that automatic stabilizers would "increase the budget deficit (or reduce the budget surplus) of federal, state and local governments by about a third of any drop in income." *Money, Debt, and Economic Activity*, 2d ed. (New York, Prentice-Hall, 1953), p. 466. The over-all deficit would, in the case assumed above, be $18 billion. My reckoning is only the *federal* deficit.

[9] CED, *Taxes and the Budget* (New York, 1947), p. 30.

Thus the virtues of built-in flexibility grow out of the defects for fiscal policy of our democratic system and of the frailties of economic diagnosis and prescription. The one reinforces the other. Even if economists knew what was wrong and what to do about it, Congress might still lag in action. This lag, in a dynamic economy, may make the prescription irrelevant. A system of flexible and current tax payments and expenditures is a protection against this fault.

The charge of arbitrariness

It has, however, been argued that a built-in system is inherently arbitrary in its implicit judgments. In depression it is arbitrary to assume that automatic reduction in government revenues and expansion in spending will equate accurately the social appraisal then of public vs. private goods. In boom, similarly, automatic contraction of spending and enlargement of revenues will (so the argument runs) bring about an optimal result only by accident.[10] This reasoning assumes that social judgments made by Congress about allocation of resources should rationally vary over the cycle. In depression, when resources are going to waste, a short-run appraisal would favor a relative shift of resources to public use; in boom an opposite shift would be indicated.

The validity of this argument is limited because need for most governmental services does not vary cyclewise. There are, indeed, exceptions, notably with respect to services rendered to unemployed persons, demand for which rises in depression and falls in prosperity. Furthermore, governmental expenditures on durable goods can economically be concentrated in depression, even though such programs meet long-run needs regardless of conditions of depression and prosperity. These two sets of exceptions do not, in principle, bring any relative shift in the *long-run* importance of the private or the public sphere; in this respect they are neutral, since the increased spending in depression is counterbalanced by reduction in prosperity. This cyclical variation is probably best handled by means of a program with a high built-in flexibility rather than by annual legislative appraisal. Legislative decisions about most other governmental pro-

10 Paul Samuelson in *Money, Trade and Economic Growth* (New York, The Macmillan Co., 1951), p. 175.

grams should be made after examination of their long-run desirability without regard to the business cycle.

A smooth shift of resources to and from public and private use, even if indicated by a short-run appraisal, is not feasible. The techniques by which resources are taken for, and released from, public and private purposes are basically different. Allocation for private purposes is performed by the market; that for public by compulsion. Public (political) allocation is therefore inherently inflexible; the available techniques for implementing it cannot achieve a ready flow of resources back and forth between public and private spheres except by programs with a built-in flexibility, the nature of which is that new social decisions over the cycle do *not* have to be made.

Built-in flexibility currently modest

Built-in flexibility is, however, arbitrary in another respect. A given amount of it would ideally be suited only to one kind of business cycle; it would be too little or too large for any other kind. This fault must be admitted, and it might be serious if built-in flexibility were very strong, bringing sharp increases in revenues and sharp falls in spending in economic recovery, and the reverse in downturn. But in fact this condition does not prevail, and several economists have warned against a very different situation: that built-in flexibility is strong enough to offset only a modest recession or to retard only a mild inflation.[11] Even

[11] R. A. Musgrave and M. H. Miller, "Built-in Flexibility," *American Economic Review* (March 1948), p. 127, state that their analysis "lends no justification to the view now growing in popularity that 'built-in flexibility' can do the job alone and that deliberate countercyclical policy can be dispensed with." They define built-in flexibility as "the fraction of the change in income which is prevented because of the existence of 'built-in flexibility.'" (p. 123). After reckoning the income elasticity of the federal tax system, 1946-1947, at 1.5, they conclude that about one third of a change in income would be offset by built-in flexibility. Alvin H. Hansen, *Monetary Theory and Full Employment* (New York, McGraw-Hill Book Co., 1949), pp. 177-80, in criticizing the CED scheme, believes that a cumulative downward surge must be offset *promptly* by stronger measures. The CED is prepared to go beyond built-in flexibility only in the event of "deep depression or acute inflation." CED, *The Stabilizing Budget Policy, op. cit.*, p. 13.

Milton Friedman feels that the built-in flexibility of government receipts and expenditures is less fundamental as a corrective than that growing out of the so-called Pigou effect. As prices decline, the real value of assets (including cash balances) is increased and this increases the consumption function with an increase in spending. The automatic correctives are, therefore,

if this is admitted, the scheme does slow down the forces of depression and boom; it gives a breathing space during which discretionary steps can be developed by the legislative process.

6. *BUILT-IN FLEXIBILITY AND THE MULTIPLIER*

High flexibility reduces multiplier

The relation between built-in flexibility and the concepts of the marginal propensity to consume and the multiplier should be indicated. Assuming that the level of investment is independent of the levels of income and taxes, and that consumption depends upon disposable income, a high multiplier is the result of a high *mpc*. A high built-in flexibility means that a change in GNP, or national income, or personal income, brings a less than proportionate change in disposable income because taxation absorbs a more than proportionate part of the change and because government expenditure moves inversely to the change. Since the change in disposable income is less than in proportion, the change in consumption is also. A high built-in flexibility will, therefore, have a cushioning effect upon recession[12] and a re-

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greater than has been reckoned by Musgrave and others. This issue is, however, in dispute and the short-run significance of the Pigou effect is especially questioned. See Milton Friedman, "A Monetary and Fiscal Framework for Economic Stability," *American Economic Review* (June 1948), p. 261; Alvin H. Hansen, *A Guide to Keynes* (New York, McGraw-Hill Book Co., 1953), pp. 178-82.

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	Year 1	*Year 2*	
		High built-in flexibility	*Moderate built-in flexibility*
National income	300	240	240
Government revenue	70	50	60
Disposable income	230	190	180
Consumption	180	152	144

If recession brings a fall in national income from 300 in the year 1 to 240 in the year 2, the value of the multiplier in the year 1, if built-in flexibility is high, will be 1.9, while if built-in flexibility is moderate, it will be 2.5. The effect of a high built-in flexibility is, therefore, to cushion the fall in consumption.

Two nongovernmental features of our present economy which, like built-in flexibility, would slow up recession are corporate savings and the large holdings of liquid assets by individuals. Corporations, in the event of decline, would tend to maintain dividends at the cost of retained earnings, and this would shelter personal incomes somewhat against the fall in GNP. Again, individuals now hold large sums in bank accounts and saleable securities; they could, through dis-saving, cushion a decline in current earnings.

straining effect upon inflation; it reduces the size of the multiplier both in the downswing and upswing. Its effects come *after* a fall or rise in GNP, or national income, or personal income. And built-in tax flexibility is not merely a matter of the income elasticity of taxation, but also of the height of the level of taxation. A tax system with a very high income elasticity which absorbed 5 per cent of GNP could make only a modest contribution toward cushioning the fall or restraining the rise of disposable income.

The concepts should be considered in relation to conditions of depression and boom.

It is reasonable to assume that, in recession, the deflationary effect of the multiplier gradually shrinks because of built-in flexibility. Resistance to further decline will strengthen and, as the turning-point is reached, an increase in government spending (or in investment) may convert the multiplier to an expansionary effect. Assuming, as seems reasonable, that the multiplier remains high for a considerable time during the upswing, the restraining effect of built-in flexibility will be modest and the upswing should go forward without halt.

As the economy passes from full employment into boom, the value of the multiplier will fall. Built-in flexibility will increase because of the marked response of the yield of taxation, especially income taxation, to inflation. The progress of the boom will be dampened down. A common difficulty in this situation is, however, that autonomous investment may be increasing and that the restraining effect of a shrinking multiplier is offset by absolute increases in investment. Effective restraint on the boom may, therefore, require tax changes which fall heavily upon investment, and also a restrictive monetary policy.

7. *INCREASED SPENDING OR REDUCED TAXES?*

Merits and demerits of spending

Does increased government spending in depression, whether discretionary or automatic, offer any net advantage compared with smaller taxes? Has a deficit arising out of spending any virtue over one produced by lower tax rates? During the New Deal, and certainly up to introduction of the Full Employment bill, an affirmative answer was assumed by many people (usually without an explicit justification). The expenditure approach has

the merit of bringing concrete advantage to particular people and areas. Expenditures are for specific purposes—building a school or giving a dole to persons who meet a means test—whereas tax cuts apply across the board. Cuts in some taxes, such as the individual income tax or the property tax, will relieve directly only those with taxable net income or property, who may in depression have no acute need for relief. If relieved, they may fail to return all or part of the cut to the income stream: there may be a "leakage." This will be large if the tax cut benefits high-income groups because in depression their savings may not be invested. What is needed then is an increase of consumption; this can be achieved by an increase in government spending which will serve not only to offset the fall in private spending, but to absorb inventories, increase liquidity, and perhaps even give a stimulus to investment.

Considerations of this sort make transfer expenditures for welfare purposes especially attractive, and humanitarian feeling furnishes reinforcement. A considerable reservoir of desirable welfare expenditures is still available, although it is smaller and more controversial than a generation ago. And confidence in the unlimited efficacy of government spending aimed at increasing consumption is also less sure.[13]

Another avenue for increased spending is public works, but only if these have been deferred in prosperity. If this is not so—if the government enlarges its agenda by making investments in functions which had been private—a net stimulative effect may not be secured because of the adverse effects on the private propensity to invest. Expenditure for make-work has the same fault.

A confident belief in spending as a sovereign remedy against depression may allow a government to cover up or excuse failure

[13] Writing in 1944 Kalecki argued that a limit to spending for useful public investments might soon be reached, but that this would not be so for spending to increase the level of consumption. "Government spending [of this type] can never fail to achieve immediately the desired employment effect if it is on a sufficiently large scale, because it generates effective demand directly. The effects of stimuli to private investment depend, however, on the reaction of entrepreneurs, and it is quite possible that when they are in a very pessimistic mood they may not respond even to considerable inducements. This may happen, for instance, if they do not feel confidence in the political situation." Oxford University Institute of Statistics, *The Economics of Full Employment* (Oxford, Basil Blackwell, 1945), p. 53.

on other fronts. While fluctuations in aggregate demand are the most important factor causing depression (and boom), they are not the only factor. Specific economic maladjustments may cause unemployment, especially in particular areas and industries. They are not cured by more spending. A government determined to *spend* enough to achieve a high level of economic activity is unlikely to consider other policies.[14]

Merits and demerits of lower taxes

The special virtues of tax reduction in a free enterprise system are related to the demerits of spending. The cuts leave the market allocation of resources undisturbed,[15] and they do not arouse fears in the minds of investors about the growth of public industry. If confined to low-income brackets, no important leakage will result.[16] Tax changes are, however, not very flexible. Congress in recession may more easily be persuaded to provide a large lump-sum appropriation for use at Executive discretion than to allow Executive discretion to make tax changes.

Perhaps the cheerful conclusion can be reached that, assuming the presence of good built-in flexibility, Congress will have time to appraise changes both in taxes and spending. Somehow it will determine at what point their use brings an equal increase in employment and social utility. Congressional acceptance of *both* spending and taxing as devices for fiscal policy would be a forward step which need not wait upon precise determination of the relative limits to their use.

In the next three chapters spending programs now in existence which have a significant built-in flexibility, or prospects of significant discretionary flexibility, will be examined. These are (a) the agricultural price-support programs, (b) the social security programs, and (c) public works.

[14] Richard Bissell, Jr., in *Postwar Economic Problems,* Seymour Harris, ed. (New York, McGraw-Hill Book Co., 1943), p. 84.

[15] Except as the distribution of income is changed.

[16] The relative expansionary merits of a deficit produced (a) by spending for goods and services, (b) by transfer spending, and (c) by tax reductions, are in dispute, although most economists probably would say that (a) has the greatest leverage. But tax changes believed to be temporary, as might happen often if fiscal policy is governing, have a high leverage. See Musgrave, "Fiscal Policy in Prosperity and Depression," *Proceedings of the American Economic Association* (May 1948), p. 384; also discussion by William Vickrey, p. 409.

9

Agricultural Price Supports

Depressions farm-bred and farm-led

In the depression after 1920 agricultural prices fell farther than did industrial and, what was more serious, they did not recover. During the rest of decade of the 1920's, when most of the economy was prosperous, agriculture lagged. Persistent efforts were made in Congress to pass price-support legislation, and in 1929, as a beginning, two corporations were established to stabilize the prices of cotton and wheat by buying surpluses when crops were abundant and feeding these back into the market when crops were short. The depressive forces after 1929 were, however, far beyond the strength of these provisions. Although by the end of 1932 the two corporations had committed the half billion dollars at their disposal, the prices of wheat and cotton had fallen precipitously. In October 1933 farmers received on the average 71 cents a bushel for wheat and 9 cents a pound for cotton. As in the depression after 1920, agricultural prices had fallen in advance of other prices, and the fall in agricultural incomes had seemed to pull down the rest of the economy.[1] Proponents of relief for agriculture expressed the view that depressions were "farm-bred and farm-led."

Price support via the CCC

The Agricultural Act of 1933, which set up the Agricultural Adjustment Administration, gave a new direction to policy: the *production* of farm products was to be restricted in order to

[1] Using 1929 as a base, prices received by farmers in 1932 were 48, while agricultural production was 97. In this period the prices of industrial commodities declined 25 percent and industrial production about 50 percent.

raise prices. Programs of production control were set up and farmers who complied with the programs were given benefit payments, the amount of which roughly was to equal the "gap" between farm incomes if prices were at "parity" and actual incomes. The revenue to meet these payments was provided by processing taxes. In 1936 the Supreme Court declared the taxes illegal, but by a quick shift in technique the benefit payments were made a charge on the federal Treasury.[2] In 1938 new legislation made price support the backbone of the program. The Commodity Credit Corporation (CCC)—established in 1933 as the agency through which price support was to operate—now was *required* to support the prices of wheat, cotton, and corn at specified percentages of parity.[3] Price support of other commodities was permitted and, in fact, the Secretary did increase substantially the number of programs. In order to secure some control of supply, acreage allotments and marketing quotas could be imposed.

Nonrecourse loans and purchase

The particular techniques utilized by the CCC should be noticed. *Storable* commodities are eligible for "nonrecourse" loans, i.e., if the price of such a commodity fell below the loan value, the government could merely take over the amount of the commodity used as security for the loan. If, when a loan matured, the market price was below the support price upon which the amount of the loan was based, the farmer would let the CCC take possession. For *perishable* commodities (and some semiperishables) the CCC supports prices by purchase.

Wartime success

In the years before World War II, and particularly during the recession 1937-1938, it seemed that this scheme was to be submerged by mounting inventories held by the CCC. The carryover of cotton and corn became greatly in excess of normal. Most

[2] By the Soil Conservation and Domestic Allotment Act of 1936 and the Marketing Agreement Act of 1937.

[3] Not less than 52 percent or more than 75 percent.

agricultural economists expected that if price support was to survive, crop controls would have to be extended. Nothing of the sort happened. With the war the reserves of corn, cotton, and wheat became windfall assets which were used to meet expanded needs. Before long the whole program was given an expansionary bias. In January 1941 the support price for cotton, wheat, corn, rice, and tobacco—the "basic" commodities—was raised to a mandatory 85 percent of parity, and in October 1942 to 90 percent.[4] In addition, the scope of the program was greatly enlarged. Whenever the Secretary of Agriculture requested an increase in the production of a commodity, he was required to support its price at the same percent as for the basic commodities. Beginning in 1941 and through World War II, about 30 different commodities were in the program. The production response to the assurance of high price supports—an assurance reinforced by the promise of support for two years *after* the war—was gratifying. Over-all agricultural production, which in 1941 was 110 percent of the 1935-1939 average, was 137 percent in 1944.

During the war years the parity ratio rose well above 100,[5] whereas during the 1920's and 1930's it was almost always below it. In 1943 the ratio was 113. This situation continued and even was exaggerated postwar with the parity ratio hitting 115 in 1947. This meant, of course, that the CCC did not have to take commodities off the market to support prices; on the contrary it fed its stocks back into the market and tended to reduce inflationary pressures. As a result, the cumulative net financial outcome of the price support operations of the CCC from its beginning in 1933 through the fiscal year 1947 was a gain of $159,100,000.

Growth in loans 1948-1949

Thereafter it appeared that the program was headed for trouble. 1948 crops were large and late in the year a modest recession began. From January 1948 to December 1949 prices received by

[4] In 1942 the support price for cotton was made 92.5 percent.

[5] This is the index of prices received by farmers divided by the parity index, i.e., the prices paid by farmers.

farmers fell 24 percent. The startling growth in the amount of commodity loans is shown below:

Table 3. COMMODITY LOANS MADE BY THE CCC, FISCAL YEARS, 1948-1953
(in millions of dollars)

	1948	*1949*	*1950*	*1951*	*1952*	*1953*
Corn	1.6	464.8	493.9	84.6	39.5	482.8
Cotton	36.7	822.2	459.3	1.7	171.7	357.4
Wheat	63.8	520.3	662.8	80.1	436.6	892.7
Other	186.6	361.9	407.3	594.4	301.6	396.3
Total	288.7	2,169.2	2,023.3	770.8	949.0	2,129.2

For three staple commodities—corn, cotton, and wheat—the amount jumped seventeenfold in 1948-1949, and for all commodities sevenfold. At once controls—acreage allotments and marketing quotas were instituted to reduce the flow of supplies, and Congress began to think of *flexible* support provisions by which the level would be lowered as supplies outstripped "normal" requirements. But again an extraordinary event—war in Korea—shifted the emphasis back to expansion. And again the government could regard its possession of reserve supplies of important agricultural products as fortunate.

The situation 1953-1954

Perhaps the long-deferred readjustment is with us currently. In 1952 farm output was at a record high and 1953 brought no important decline. Foreign demand for American farm products weakened so that in the fiscal year 1953 the value of farm exports dropped by 31 percent from 1952. Agricultural inventories piled up, with a sizable portion coming into the hands of the CCC. In early 1954 Congress had to extend the borrowing authority of the CCC from $6.75 to $8.5 billion, and later to $10 billion.

Faced by these conditions, the Eisenhower administration offered a new farm program to the Congress. In essence, it proposed that the flexible price supports of the agricultural acts of 1948 and 1949 which had been held in abeyance, be made operative. For the basic commodities these would provide price

floors ranging from 75 to 90 percent of parity, and varying with the supply. Congress provided floors ranging from 82½ to 90 percent. A modernized parity, taking into account the relationship of the price of a commodity to other farm products during the past ten years, would become effective January 1, 1956, for wheat, corn, cotton and peanuts.[6]

Fears for the future

Most agricultural economists believe that revision of our agricultural program is overdue. An eminent group recently stated:

> Frankly, we think that the evolution of national farm policies has now brought agriculture into a position of undue reliance on public financial assistance, on efforts to restrict market supplies, and into undesirable political involvement. This situation breaks not only with past traditions of American farmers but also is not consistent with a forward-looking economic program for the whole economy.[7]

The price supports are, so they feel, too high and too rigid; the parity formula is out of date and tends to distort production and consumption; production controls may be shifted from a voluntary to a compulsory basis, and a real danger exists that, with depression, they may be widely extended in order to make the program work. Mention—if not appraisal—of these fears is relevant to analysis of the agricultural price supports as a countercyclical device.

Losses in support of perishables

The price supports so far have provided floors under the prices of specified agricultural commodities. The CCC makes a floor effective by loans, by agreeing to purchase, or by actually purchasing the supported commodity. For perishables the only method of operation is outright purchase, and, in case of trouble, the impact upon government finances and public consciousness is prompt. The most notable instance was Irish potatoes of which a flood came into the possession of the CCC in 1948-1949. Return to the market was impossible without creating new price problems, and so also was disposal by donations for uses which would

[6] It is already in use for other commodities.

[7] *Turning the Searchlight on Farm Policy*, by thirteen agricultural economists (The Farm Foundation, 1952), pp. 62-63.

be in *addition* to and not simply in place of regular uses. The outcome was disposal for nonfood purposes and by destruction. Potatoes were dropped from the price-support program, but the CCC suffered a net loss of $478 million—75 percent of the total sum it had invested in potatoes and 40 percent of its net losses from the inception of the program to November 1953.[8]

But not on durables

Storable commodities obviously allow a period of grace during which they may be sold without loss. Stocks of them can cause concern to the CCC only when their amount exceeds some normal carryover. Unless the market for a commodity strengthens to a figure above the support level, it cannot be fed back into market channels. The prospects will then be cutbacks in production, a lowering of support prices, and—less immediately—revival of some form of food distribution program on the model of the stamp plan of the 1930's. But for the basic commodities the net loss has been only about $165 million.

The program as a built-in stabilizer

It should be apparent that the agricultural price-support program, as now in operation, provides a substantial built-in stabilizer. An agricultural economist, writing in 1952, declared: "It has tended to strengthen prices in periods of deflation and to restrain prices in periods of inflation. It has helped make the economy more stable. It has probably benefited non-farmers, as well as farmers."[9] Ten percent of national income originates in agriculture. The farm market for nonfarm goods and services was in 1951 almost $29 billion.

> In 1951 farmers spent about 4 billion dollars, or 1 dollar out of every 9 received from the sale of farm products, just for the purchase of autos, trucks, tractors, and other farm machinery. Expenditures for these items were the equivalent of about 700,000 non-farm persons employed. On the other hand, in 1932 farmers spent less than 200 million dollars, or only 1 out of every 25 dollars received from marketings for autos, trucks, tractors, and other farm machinery. In

[8] Total net losses in this period have been $1,195 million with eggs ($190 million) and dairy products ($137 million) ranking below Irish potatoes.

[9] Frederick V. Waugh, "What Sort of Price Policy Is Practical in the U. S. A.," *Journal of Farm Economics* (December 1952), p. 608.

1932, farm expenditure for these items represented employment of only 100,000 non-farm persons.[10]

By retarding or halting a downward spiral in farm prices and in farm incomes, the price-support program contributes toward high-level stability for the economy. This assumes, to be sure, that the supports will be held or not markedly lowered and that farmers will retain confidence in the program. These assumptions are plausible. The parity ratio, it should be remembered, indicates a relation between prices received and prices paid by farmers. If, in depression, both farm and nonfarm prices fall equally, the ratio will remain unchanged. But if, as has usually happened, nonfarm prices fall less than farm prices, the CCC will promptly incur heavy financial commitments—witness the very sharp upsurge already cited. From the June quarter of 1948 when total CCC investment in price-support operations was $294.0 million, the figure grew to $2,163.4 million by the December quarter and to a peak of $4,227.4 million in the March quarter of 1950 (See Table 4 and Figure 1). Thereafter investment fell, although not to the 1947 level. But in late 1952 a new upturn began which is still in process.

The figures of investment, it should be noted, do not become budget outlays unless and until actual losses occur in final disposal of commodities, i.e., the outlays are recoverable to the extent that loans are repaid or commodities are disposed of without loss. Moreover, the figures must not be regarded as the net addition to national income or purchasing power even in the short run. Some part of the CCC investment may replace private outlays financed through credit expansion, and some part has a transfer effect in so far as consumers of agricultural commodities have to pay higher prices because of the price-support program. Yet while precise measurement is not possible, the fact is that an important countercycle effect comes into operation, stronger on the downswing than during the boom.[11]

[10] U.S. Department of Agriculture, Production and Marketing Administration, *Price Support Handbook* [Washington, November 1952 (mimeographed)], p. 27.

[11] It is arguable that the postwar program, with its high level of supports, has actually had an inflationary bias. See *Turning the Searchlight on Farm Policy, op. cit.*, p. 38. But this position is at least questionable (*ibid.*, 50), and certainly in the period of quasicrisis shortly after the start of the Korean war the program put some damper on inflation.

Table 4. QUARTERLY NET INCOME OF FARM OPERATORS AT SEASONALLY ADJUSTED ANNUAL RATES, INVESTMENTS IN PRICE-SUPPORT OPERATIONS AT END OF QUARTER, 1946-1953

Year and Quarter	*Net Income of Farm Operators (billion $)*	*Investment in Price-Support Operations (million $)*
1946 I	13.3	712
II	13.5	446
III	16.0	380
IV	16.4	411
1947 I	16.0	456
II	14.5	415
III	15.0	485
IV	17.0	565
1948 I	16.7	490
II	18.8	294
III	18.0	775
IV	17.2	2,163
1949 I	14.4	2,595
II	12.8	2,692
III	12.0	3,112
IV	11.8	3,701
1950 I	12.4	4,227
II	12.2	3,628
III	13.9	3,098
IV	14.8	2,905
1951 I	15.1	2,452
II	14.4	1,770
III	15.8	1,892
IV	17.0	2,012
1952 I	15.4	1,778
II	14.8	1,439
III	15.2	1,903
IV	15.5	2,474
1953 I	13.4	3,268
II	12.4	3,646
III	11.6	
IV	12.2	

Source: Commodity Credit Corporation Charts, U.S. Department of Agriculture (Washington, November 1953), Table 7.

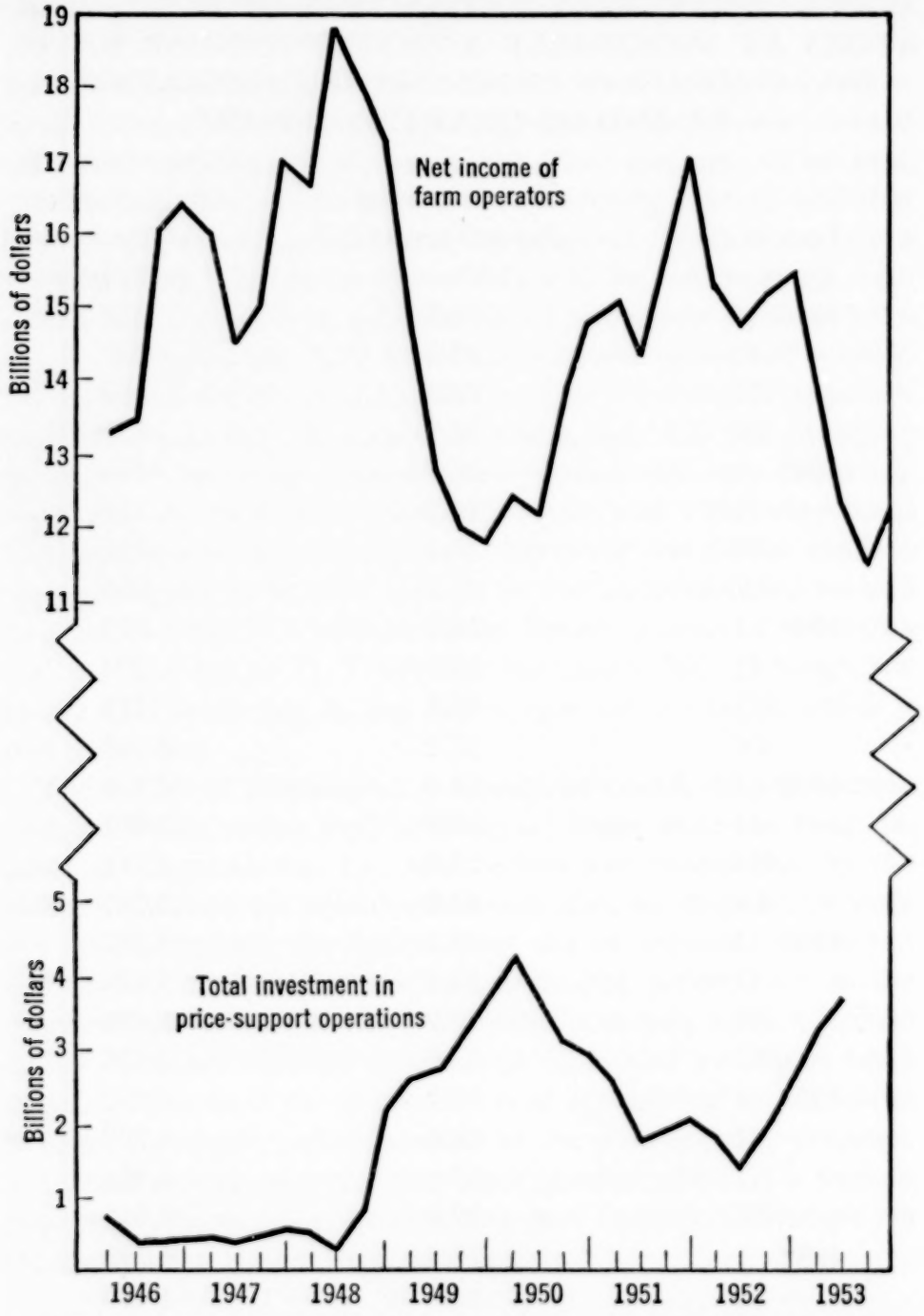

FIGURE 1. Quarterly net income of farm operators at seasonally adjusted annual rates, total investment in price-support operations at end of quarter 1946-1953.

Operation partly by formula

Two further features of the price-support program of interest to framers of *other* countercycle schemes are the use of a formula to direct operations and the delegation of wide authority to an Executive officer, the Secretary of Agriculture. No detailed history need be given to establish these points. A parity formula relating prices paid by farmers to prices received by them 1909-1914 has always been in the program, while the percentage level of parity has sometimes been specified and sometimes left to the discretion of the Secretary. The parity formula has been under heavy fire, and surely it is not hard to be critical of a formula which enforces farm-price relationships prevailing before World War I. At the very least, the formula needs improvement. But the persistence with which Congressmen—practitioners of the art of the possible—have held to the formula indicates a conviction that it provides a practical means of operation. A specific formula does bring pressure from friends of agriculture for alterations which are inflationary. But perhaps this pressure can thereby do less damage than if directed toward the framing of an entirely new formula. In an economy where economic and political forces brought prompt shifts from one equilibrium situation to another, operation by formula would be indefensible; in the economy we have, "practical" reasons for a formula are impressive.[12]

Operation partly by discretion

The other remarkable feature of the agricultural program is wide delegation by Congress of discretionary power to the Executive. For example, in the AAA Act of 1933 the Secretary of Agriculture had wide latitude in setting the loan rate, and in 1938 he could specify rates ranging from 52 to 75 percent of parity. Thereafter, Congress circumscribed the authority of the Secretary, but he still has extensive powers. Of the twenty-six price-support programs in 1952 only twelve were mandatory. After considering certain factors—the supply of the commodity in relation to the demand, its importance in the economy, etc.—the Secretary was authorized to support the prices of any agricultural commodity and, in 1952, he designated fourteen. For these non-

[12] Waugh, *op. cit.*, pp. 611-12.

mandatory commodities the Secretary, after consideration of the same factors which led to their designation, had considerable discretion in setting the support levels.

Can it be inferred that these precedents would dispose Congress to embody formulas in other countercyclical measures as well as to delegate wide discretion to the Executive? Or is the agricultural program unique in the mind of the Congress?[13]

[13] A plan for government purchase of storable raw materials at predetermined prices has been proposed by Benjamin Graham, *Storage and Stability* (New York, McGraw-Hill Book Co., 1937), and by F. D. Graham, *Planning and Paying for Full Employment* (Princeton, Princeton University Press, 1946), pp. 40-66. Such a scheme would be countercyclical by preventing price collapse and by maintaining production in depression. The major problems concern disposal, since inevitably the government would have to carry large supplies for indefinite periods.

10

Social Security

1. INTRODUCTION

Social security programs in the United States are of three broad types: (1) the public assistance programs for (a) old age assistance, (b) aid to dependent children, (c) aid to the blind, (d) aid to the permanently and totally disabled, (e) general assistance; (2) the two social insurance programs for old age and survivors' insurance (OASI) and unemployment insurance; (3) a miscellany of service programs.

The finances of public assistance

Expenditure for the public assistance programs in 1952 was as follows:

	Total Expenditure (million $)	*Federal (percent)*	*State-Local (percent)*
Old age assistance	1,616	53	47
Dependent children ...	605	53	47
Blind	66	47	53
Permanently and totally disabled	103	50	50
General assistance	258	—	100
	2,648	48	52

As the figures show, the financing of four of the programs is shared among the three levels of government. The federal contribution is by grants-in-aid which have trended toward somewhat greater liberality from the beginning in 1935. At present the federal government will reimburse state and local govern-

ments for expenditure on old age assistance, aid to the blind, and aid to the permanently and totally disabled as follows: four fifths of the first $25 of the average monthly payment per recipient, plus one half of the remainder up to a maximum of $55. Similarly it will reimburse for expenditure on aid to dependent children as follows: four fifths of the first $15 of the average monthly payment to one child plus one half of the remainder up to a maximum of $30 for the first child and $21 for each additional child. It should be noticed that responsibility for general assistance falls entirely upon the state and local governments with no federal aid.

Finances of the social insurance programs

OASI and unemployment insurance provide respectively for payments to eligible persons who are retired from employment, and to eligible unemployed workers, which in fiscal 1952 totaled $3.3 billion. In addition, other social insurance programs —railroad, public employee, and temporary disability (four states only)—made expenditures of $1.5 billion, bringing the total of social insurance expenditure up to $4.8 billion. The insurance programs are on a contributory basis. For OASI payroll taxes are now levied at the rate of 4 percent—2 percent on employers' payrolls and 2 percent on employees' wages; for unemployment insurance the rate is 3 percent *less* deductions which currently reduce the effective rate for the nation to 1.5 percent on covered payrolls.[1] Contributions in fiscal 1952 were $3.9 billion for OASI, $1.6 for unemployment insurance, and $2.3 billion for the other programs—a total of $7.8 billion. This was larger than payments ($4.8 billion) by $3 billion.

Finances of the service programs

The "service" programs, as the name implies, provide services rather than money to the recipients, and the most important of them deal with health problems. Financially the service programs are relatively unimportant, and they have no current significance for fiscal policy.

[1] The ceiling is $4,200 per worker for OASI and $3,000 for unemployment insurance.

Effect on consumption

The insurance programs are distinctly sensitive to economic conditions, with unemployment compensation most important. In recession it is a first line of defense against unemployment by providing covered workers with benefit payments. OASI is less sensitive. Nonetheless, when workers over 65 years of age who had remained in the labor force are forced out by depression, the benefits they then draw are a partial substitute for earnings.

It is not to be assumed that, if social security benefits and payments are in balance, the net effect on consumption is zero. On the contrary, it is stimulative. Perhaps one quarter of contributions reduce private *saving* and three quarters reduce consumption. Benefits, however, since they are only a partial substitute for loss of earnings, are probably spent wholly for consumption. *Equality* of benefits and payments, therefore, encourages consumption. In order to leave consumption unaffected, possibly $1.33 in payroll tax has to be collected for every $1.00 of benefits.[2] In a year of high employment the amount collected greatly exceeds the amount paid out in benefits—in 1950-1951 the ratio was about $1.70 to $1.00—and the result was, therefore, markedly restrictive of consumption.

The public assistance programs are obviously redistributive and tend to be stimulative to consumption even in good years. They channel payments to people who meet a means test, using funds secured from general revenues.

2. *THE PUBLIC ASSISTANCE PROGRAMS*[3]

In December 1952, 2,646,000 persons were receiving old age assistance, 1,495,000 children in 570,000 families aid to dependent children, 99,000 persons aid to the blind, 164,000 persons aid as permanently and totally disabled, and 441,000 persons general assistance. Thus over 3,920,000 persons were on public assistance in a year of general prosperity, and total government payments

[2] S. J. Mushkin and Anne de Scitovsky, "A Formula for Social Insurance Financing," *American Economic Review* (September 1945), p. 650.

[3] In this section and the next I have borrowed heavily from Chapter 3 of my book *Federal Grants and the Business Cycle* (New York, National Bureau of Economic Research, 1952).

for them in 1952 were $2,390 million. In future years growth in the number entitled to benefits under OASI, extension of the coverage of OASI and of unemployment insurance, together with liberalization of benefits, may be expected to reduce the number of recipients of public assistance. But public assistance seems likely to remain an important part of the welfare program of government, and, in terms of expenditure, an important element in the system of federal grants.

Total payments insensitive to business conditions

Total governmental payments (including federal grants) for the three categorical programs, i.e., those for the needy aged, dependent children, and the needy blind, grew steadily from $218 million in 1936 to $2,390 million in 1952, with no sign of sensitivity to business conditions. The behavior of payments, however, conceals variability in the *number* of recipients. During the period of World War II recipients in all three categories declined under pressure of manpower shortages, high earnings, and generous government allowances to dependents of service men. The change in numbers was, however, offset by the increase in the average payment per recipient growing out of the rise in prices, relative ease in state-local budgets, and larger federal grants.

In the future similar factors will continue to operate. A modest decline during prosperity in the number of recipients is likely to be offset by larger average payments; in depression an increased number of recipients will be offset by smaller average payments. In short, expenditure for the assistance categories is unlikely, under the present system, to show built-in flexibility. Alteration is, however, worth consideration, because the present system is defective in several respects.

Distortion of state budgets

Categorical grants have distorted state budgets. The "distortions" are both interstate and intrastate. Interstate distortion occurs when some states have too many eligible recipients, or draw disproportionally large amounts in grants, as compared with other states; and conversely when some states have too few recipients and draw too little as grants. Intrastate distortion

occurs when a state spends disproportionally on these functions compared with other functions. In a federal nation, heterogeneous in standards, customs, and wealth, uniformity in such matters would not be expected. The relevant issue is the degree to which the diversity is a matter for federal concern.

Interstate differences in eligibility and average payments

The Social Security Act specifies certain conditions for the receipt of grants, e.g., age, residence, etc., but the federal government has no voice in defining need and hence no control over the number declared eligible. This is a matter for state determination; as a result, the relative number of recipients varies widely. For example, the proportion per 1,000 of the population 65 years and older receiving old age assistance in June 1953 ranged from 599 in Louisiana and 450 in Oklahoma to 58 in Delaware and 49 in New Jersey. Some tendency exists for the "rich" states (those with higher than average per-capita income) to have a low recipient rate, and for "poor" states (those with lower than average per-capita income) to have a high one, but exceptions are numerous. It seems certain that a considerable part of this variation arises from differences in definition and appraisal of need, as well as from differences in need itself.

Average payments for old age assistance range from a high of $84.22 for Colorado in December 1952 to a low of $25.70 for Virginia. These payments tend to be higher in richer and lower in poorer states, although again there are notable exceptions. Federal grants have, it appears, allowed a wide spread to prevail in these payments which are subject to a means test.

The amount of federal money provided as grants also varies widely from state to state, although no clear pattern emerges.

Interstate differences in effort

Is the relatively low level of payments by many of the poorer states attributable to their poverty or to a lack of fiscal effort? If per-capita income is taken as a measure of the richness or poverty of a state, and the percentage of income payments devoted to a function as a measure of fiscal effort, the *broad* pattern shows that many—perhaps half—of the poor states appear not to make an average fiscal effort; their relative expenditure for cate-

gorical assistance is a smaller fraction of their income payments than the national average. But the further fact emerges that the poorest of the poor states could not achieve the national average level of payments even if they made an average fiscal effort.

Intrastate distortion

The attraction of federal grants has induced the poor states—and some rich—to spend heavily for categorical assistance compared to other functions. The distortion is most evident with respect to general assistance, a catch-all program covering mostly unemployables who are ineligible for categorical aid, i.e., under 65 years of age and not blind, and some employables who are outside the social insurance programs. In 1952 Delaware and New York, at one extreme, spent one and seven tenths and twice as much for old age assistance as for general assistance; Mississippi and Texas, at the other extreme, spent 122 and 60 times as much. It is an historical accident that some categories of public assistance receive federal grants while others do not.

3. GENERAL ASSISTANCE

Sensitivity of number of recipients

The number of recipients of general assistance is quite sensitive to business conditions. The recession of 1937-1938 and that of 1948-1949 brought an increase, while recovery brought decline. The general assistance program is a shock absorber for a considerable number of persons in the event of depression. In good times most recipients are unemployables; in bad times the number is swelled by employables not covered, or inadequately covered, by social insurance.

Situation in poor states

Since 1941 the number of recipients has been remarkably low because of the prevalence of high employment. In 1940 the figure was about 1,500,000; in February 1953 it was 287,000. The poor states in general have a relatively low recipient rate (that for Mississippi is 4-5 percent of that of New York) and make very low average payments. It seems certain that in most poor states

a suppressed demand for general assistance would in the event of depression make itself felt and throw an extra financial burden upon them which they could not handle.

Extension of federal grants to general assistance has been given considerable support. Congress has, however, refused to act. It is aware of the defects of the categorical grants and especially of their amazing growth. General assistance grants might, unless safeguards were provided, bring new abuses and heavy financial responsibilities. Safeguards are, besides, not easy to provide. The most obvious method would be through "conditions"—standards of performance—which states must meet. These might aim at securing similar appraisal of need and fiscal effort state by state, thereby limiting state autonomy. Such an approach would encounter resistance from influential groups which object to federal encroachment and which hold that federal grants should carry less, rather than more, conditions. The conflicting positions pose obvious dilemmas which can, however, be resolved in principle.

4. *A PROPOSAL FOR REFORM*

"Block" grants for public assistance as a *whole*

The argument that federal grants for old and well-recognized functions of government should have few conditions is widely endorsed, and it makes sense when applicable to broad, rather than narrow, fields of expenditure. Public assistance is such a broad field, and it is plausible to suggest that the federal government offer grants for it. This would not mean merely that grants for general assistance be added to those for old age assistance, the blind, dependent children, the disabled. Rather would the grants be for the field as a *whole* with no federal specifications concerning the particular categories. The grants would be "block" grants for public assistance.

In such case how would the annual aggregate of federal grants for public assistance be determined? How might the grants be distributed among the states?

A "closed" grant

At present the annual aggregate of grants for categorical assistance depends primarily upon state-local decision. The federal law sets ceilings upon the payments per recipient which it will share, and it makes broad specifications concerning age and residence. Otherwise the federal obligation is not restricted. After the state and local governments decide what needy persons are to be put on the rolls and what payments are to be made, the amount of the federal grants as reimbursement follows automatically. The grants are "open-end." Diversity in eligibility and dissimilar treatment, state by state, of persons in similar circumstances are tolerated by the federal government because an attempt to press for uniformity would be administratively difficult and politically distasteful. If, as has been suggested above, a block grant for public assistance is offered, the open-end feature could not be continued. Congress would, instead, set up a "closed" grant, i.e., it would determine yearly the amount it wished to appropriate for public assistance by a process parallel to its determination of the appropriation for each governmental function. For example, Congress might decide that a total governmental expenditure of $3,000 million for a particular year would provide a minimum acceptable level of service and that it would provide some fraction of this by grants.

National minimum and standard effort

One possible technique for allocation of the aggregate of grants among the states would be to determine a national minimum or foundation level of expenditure for a bundle of services (a function) which, in the opinion of Congress should be provided even in the poorest state. Suppose, as above, this requires annual expenditure of $3,000 million, or approximately $20 per inhabitant. In Figure 2 this is represented by the line *cz*. In allocating grants the Congress might well be concerned about what should be the fiscal effort of the states. The best measure of state fiscal *ability* is income payments and of fiscal *effort* is the percentage of income payments raised and spent. Suppose that Congress decides that the state-local governments should devote half of 1 percent of income payments (of $300 billion) as a "standard"

fiscal effort to public assistance, then the aggregate would be $150 million. A given percentage would, of course, raise less per inhabitant in a poor than in a rich state. In Figure 2 the states are (hypothetically) ranked from low to high, *A* being the poorest and *Z* the richest. State *A* by a standard fiscal effort would secure *Aa* per inhabitant, state *Z* would secure ZZ_1. As illustrated, it is apparent that approximately half the states (*A* to *M*) could *not* achieve a national minimum expenditure per inhabitant by making a standard fiscal effort. The area *acm* represents the

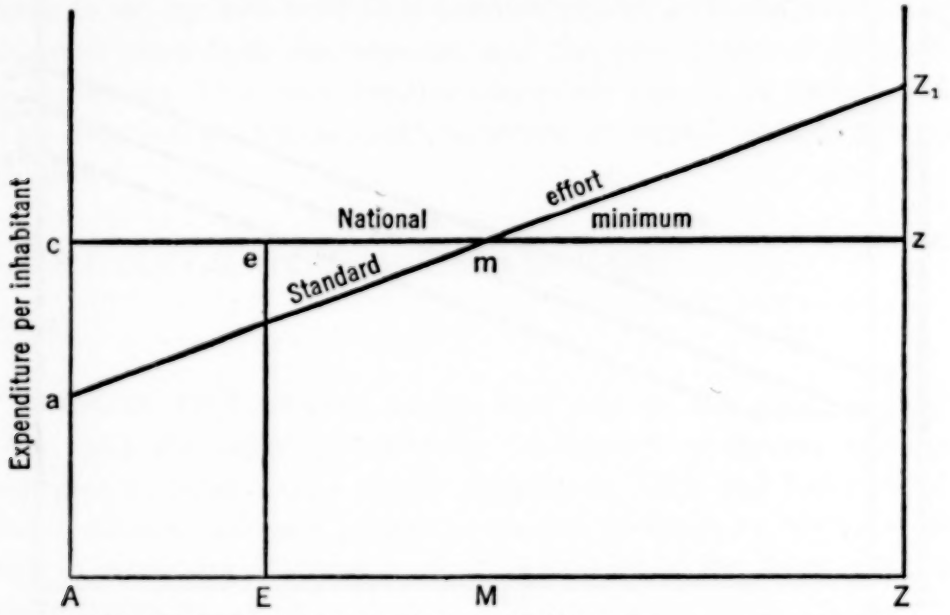

FIGURE 2. Idealized high standard effort, low national minimum grants.

amount of federal grants per inhabitant required as a supplement to bring them up to the acceptable level. States to the right of *M* require no grants for this purpose; states to the left of *M* would secure grants which made up varying percentages of their expenditure with the poorer states obtaining larger relative shares. The belief is widely held, however, that the federal grant percentage should not rise for any state above approximately 75 percent because this might impair state-local administration. The essence of a program of conditional grants is that administration and supervision be in state-local hands, and effective performance might be impaired when their financial participation fell to a low figure.

It should be obvious that the national minimum and the standard effort could be set higher or lower so as to enlarge or reduce the grant program. A low minimum and a high standard effort would make less states eligible for grants; a high minimum and a low standard effort would make more. Figure 3 illustrates a case in which all states are eligible.

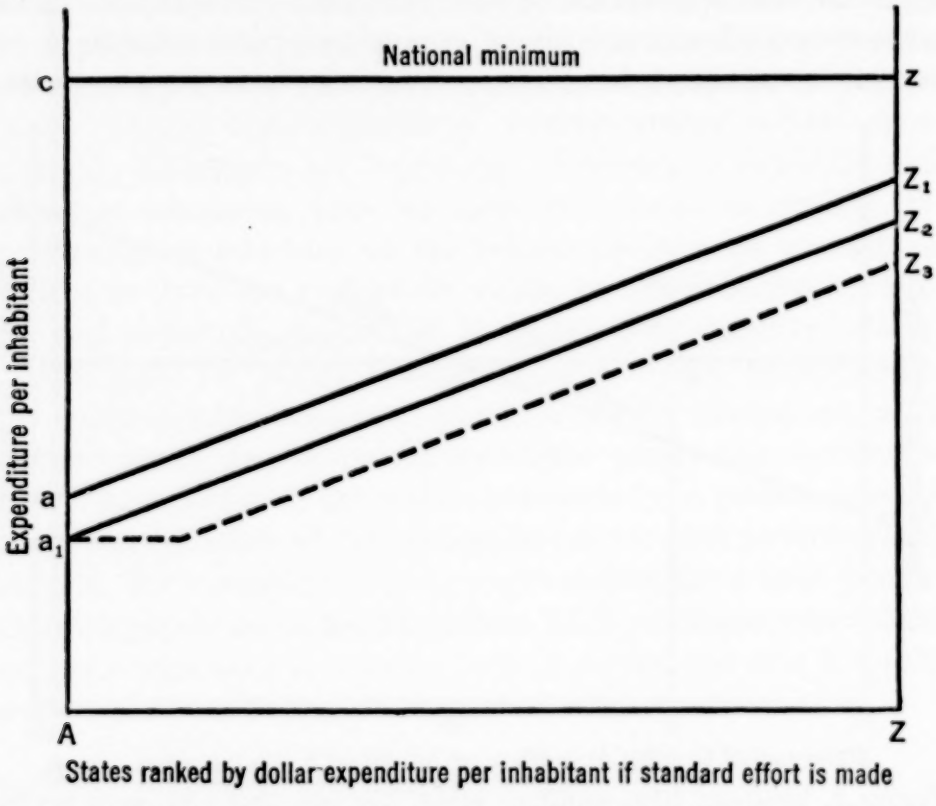

FIGURE 3. Idealized low standard effort, high national minimum grants.

High built-in flexibility of this program

A grant program set up on the above principles would have a high built-in flexibility. The curve of standard effort aZ_1, would rise in years of prosperity and fall in years of depression, bringing a fall in grants in the former case and a decline in the latter. And the figures (because they are on a per inhabitant basis) do not illustrate the rise and fall in expenditure and grants attributable to shift in the *number* of recipients. As has been stated, general assistance is in this respect very sensitive to business conditions, while old age assistance, etc., are less so. A detailed calculation would not be worth while, but a rough

calculation indicates that total expenditure might swing from say $2,500 million in a good year to $3,500 million in depression, with the aggregate federal share swinging from 25 percent to 75 percent. This swing is important for fiscal policy. In depression many state and local governments could not meet heavy demands for public assistance without expansion of federal aid; in prosperity a decline of federal aid would restrain state-local expansion of payments.

The scheme bristles with political difficulties. Congress would have to set up and hold to a countercyclical formula, decreasing in good years both the amount and the percentage of its grant expenditure. This may require discipline not to be looked for. The technical problems could, however, be solved without serious trouble.

5. *THE SOCIAL INSURANCE PROGRAMS*

OASI

OASI in 1953 covered about four out of five paid civilian jobs, and the other government retirement programs—railway retirement, federal civil service retirement, state and local retirement systems, military programs—raised coverage to nine out of ten. A summary statement of their financing for fiscal 1951 is given below:[4]

	Expenditures	*Contributions*
	(in billions)	
OASI	$1.6	$3.1
Other social insurance (railroad public employee, temporary disability)	1.4	2.2
	$3.0	$5.3

In what follows attention will be focused on OASI, because it is by far the most important and because details concerning the other programs would obscure the main theme.

[4] Ida C. Merriam, *Social Security Financing* (Washington, Federal Security Agency, Bureau Report No. 17, 1952), p. 25. Figures for veterans programs are not included.

Retirement of older workers in recession

Under OASI benefits are payable to workers who retire at the age of 65 or later, and also to survivors—young widows with children, aged widows, orphaned children, and dependent parents of insured workers. The primary insurance benefit, which now accounts for most of the expenditure, is calculated (beginning January 1, 1955) as follows: 55 percent of the first $110 of average monthly wage, plus 20 percent of the next $200 (based on the maximum wage and tax base of $4,200 per year). At present the age of retirement for primary beneficiaries is 65 years. Thereafter, until the age of 72 years is reached, a person on the rolls can earn $1,200 annually without loss of benefits. No limit is set upon the earnings of insured persons 72 years and over. During World War II many older people took work and in the postwar years only 60-65 percent of persons aged 65 years and over who had insurance rights were actually drawing benefits. In March 1953, 1,900,000 persons were working even though they had insured status and could draw benefits, if they retired, amounting to about $1.4 billion a year. A result, therefore, of the high level of employment is that benefit payments are appreciably below what they would be in the event of recession. Here is an important element of built-in flexibility.

Contribution rate not countercyclical

The contribution *rate* schedule of OASI as a *rate* is not countercyclical except against inflation, and then only by accident. When the system was set up in 1935 the tax was to be 2 percent 1937-1939, and then to climb so that, for 1949 and thereafter, it would be 6 percent. This scale, in relation to benefits, was to permit accumulation of a reserve fund of $47 billion by 1980. The original plan has been greatly modified by Congress, starting in 1939. In some quarters the deflationary effect of the scheme was blamed for the recession of 1937-1938. Congress first refused to increase the rate and then left it unchanged at 2 percent (1 percent on employers and employees) through 1949. This marked a shift in opinion away from the high-reserve scheme and also recognition that the net financial result, because of high employment in the war and postwar years, had been less costly

than was reckoned in 1935. In 1950 Congress provided a new schedule. The rate was to be 3 percent beginning in 1950, with a rise to 4 percent in 1954, to 5 percent in 1960, to 6 percent in 1965, and to 6¼ percent in 1970. So far as the record shows, the contribution rate for OASI has been used for the purposes of fiscal policy only in 1939.

Some of the many proposals for expansion of OASI would, if properly timed, be deflationary. For example, lifting the wage ceiling to which the payroll taxes apply from $4,200 to $4,800 would add $4 billion to collections with little or no *immediate* effect on benefits. Placing OASI on a so-called level premium basis would, if the system is to be self-supporting, require a rate of 6.0-6.4 percent and be strongly deflationary. But these steps are not reversible.

No serious proposal to make the contribution rate for OASI countercyclical has been advanced. Those who stress the insurance aspect and the contributory principle fear both would be impaired by rates variable with the cycle. This position would be more impressive if Congressional policy with respect to the rate schedule had been firmer. But until a firm long-run schedule of rates can be premised, it would seem superfluous to suggest cycle-variable rates which moved above the long-run schedule in boom and below it in depression.

Countercycle effect of base changes and shifts of older workers

For the present, therefore, the countercycle effect of OASI will depend upon change in *aggregate* contributions growing out of change in the payroll base and withdrawal or entry into the covered labor force of insured persons over 65 years of age. At present, as has been indicated, a severe recession might cause 1,900,000 such persons to begin drawing annual benefits of $1.4 billion, and this would be a substantial offset to a fall in their incomes. Moreover, the taxable payroll base is quite sensitive to economic conditions, and, in the event of recession which brought a decline of 10 percent in GNP, it might fall by 15 percent with a corresponding fall in contributions. It should, however, be kept in mind that the contributions from the employer payroll tax, as compared with the contributions paid by the employees and the self-employed, have no direct effect on consumption.

Unemployment insurance

In principle unemployment insurance is the most direct and automatic of stabilizing devices. When a worker becomes unemployed, unemployment benefits are paid to him which offset part of the loss of labor income. Moreover, the tax base of his employer will have shrunk because of the payroll decline. Conversely, when employment increases, the amount paid in benefits declines, and the tax base grows. The countercyclical effect is, therefore, twofold. Unfortunately, this effect in relation to contributions has been impaired by what has happened to the *rate* of the payroll tax.

Decline of ratio of benefits to taxable wages

In the early days of unemployment insurance the average contribution rate on payrolls stayed close to the original rate of 2.7 percent allowed as an offset against the federal tax of 3 percent. Benefit payments, on the other hand, were smaller than had been anticipated even before the remarkable drop in unemployment which came with World War II. During the war years unemployment nearly disappeared, benefit outlays shrank, and reserve accumulation mounted. Despite considerable liberalization of benefits by the states, the ratio of benefits to taxable wages declined from 2.2 percent in 1938 to 0.1 percent in 1943. In 1943 and 1944 the interest earned on combined state reserve funds exceeded total benefit disbursements. Attempts were made, without success, to allow the states to reduce contribution rates for *all* employers. When this failed, the swing, already underway toward adoption of experience rating accelerated. By it, employers with a good employment record are allowed a reduced rate of tax, and this became attractive not only in itself, but also as a technique to reduce rates and check the accumulation of unneeded reserves. By 1945 only six states had failed to adopt it, and by 1948 these six had capitulated. The effect of experience rating in reducing the average employer contribution has been startling.[5] Table 5 shows what has happened:

[5] Employee contributions, required at one time in nine states, nearly vanished under the impact of growing reserves and experience rating. Only two states, New Jersey and Alabama, retain employee contributions.

Table 5. AVERAGE EMPLOYER CONTRIBUTION RATE FOR STATE UNEMPLOYMENT INSURANCE PROGRAMS

Year	*Rate*	*Year*	*Rate*
1938.....	2.75	1945.....	1.71
1939.....	2.72	1946.....	1.43
1940.....	2.69	1947.....	1.41
1941.....	2.58	1948.....	1.24
1942.....	2.19	1949.....	1.31
1943.....	2.09	1950.....	1.50
1944.....	1.92	1951.....	1.64

Source: Ida C. Merriam, *Social Security Financing* (Washington, Federal Security Agency, Bureau Report No. 17, 1952), p. 61.

The provisions of experience rating are diverse from state to state, but in general the states specify that an employer can receive a reduced rate of tax only after an experience period, usually three years, and require also a minimum fund balance in relation to benefit payments. At present state unemployment reserve accumulations total about $8 billion, and, as an aggregate, this is reasonable. But the reserve is split into fifty funds. Moreover, the states differ markedly in their average benefit costs, and in their year-to-year variation in unemployment. Thus benefit costs as a percent of taxable wages averaged 1.4 percent for the United States as a whole 1946-1951. "By States, however, they ranged from 0.4 percent in Colorado and Texas to 3.1 percent in Rhode Island." A comparison in terms of reserves is at least as revealing.

> Averaged for the United States as a whole, the funds available for benefits at the end of 1951 amounted to 8.6 percent of taxable payrolls, or sufficient to pay benefits at the 1946-51 average annual rate for more than 6 years—without any further contribution income. Rhode Island, however, had reserves amounting to only 3.7 percent of payrolls and could have financed benefits for only a little over a year with funds on hand, while Kentucky, with reserves amounting to 13.1 percent of taxable payroll, could have financed benefits for almost 12 years. Colorado, with slightly lower reserves in relation to payrolls, also had lower costs during the 6 years and could have financed benefits at the same average rate for almost 27 years without collecting any further revenue. Iowa, New Mexico, and Wisconsin

also had sufficient reserve funds to finance benefits at the 1946-51 rate for more than 20 years.[6]

Present perversity of contribution rate

The point of the above evidence is simple: one feature of an ideal countercyclical scheme would be an increase in aggregate contributions in prosperous times when payrolls are expanding and a decrease when they are declining. The effect on contributions would be greatest if the rate rose in the former case and fell in the latter. The present system departs from this ideal because the contribution rate tends to fall in good times and rise in bad. As will be seen from Table 5, the average rate fell steadily 1938-1948. Part of the fall came because the original rate was set too high, but part came also because unemployment was *low*. After 1948 the average rate increased because a modest recession brought expansion of benefits and a decline in reserves. Four states were forced to suspend reduced rates "for rate years beginning in 1950, charging all employers the standard rate or above. Four States suspended reduced rates in the 1951 rate year, also."[7] As a result, the national average contribution rate rose 1949-1950 when insured unemployment as a percent of covered employment was quite high as the following figures show:

	Insured Unemployment as Percent of Covered Employment	*Average Employer Contribution Rate*
1948	3.0	1.24
1949	6.2	1.31
1950	4.6	1.50
1951	2.8	1.64

Modest countercyclical flow of benefits

The flow of unemployment benefits is clearly countercyclical, but the weight of the benefits as offsets to loss of labor income is quite modest, since benefits at present are only one third of

[6] Merriam, *op. cit.*, p. 69.

[7] *Ibid.*, p. 67. The usual method of protecting a state fund is to provide that all employers will be taxed at a rate of 2.7 percent when the fund reaches a danger point in terms of benefits, or payrolls, or level in terms of dollars.

average wages.[8] Full offset is, of course, no part of the scheme. Both for reasons of administration and of worker incentives, weekly benefits are computed so as to be less than the weekly wage, waiting periods are imposed, a limit is set on the number of payments in a year, and some types of loss of labor income, e.g., loss of overtime work, cuts in wage rates, are not compensable.

The offset provided by unemployment benefits to loss in labor income in the recession 1948-1949 can be calculated. Starting from a peak of labor income in September 1948, a trough was reached in February 1950, and by July 1950 the level of labor income had climbed above the initial peak. If a calculation is made of the cumulative amount of the loss in private wages and salaries, and the cumulative amount of the benefits, from September 1948 to July 1950, it will be found that the latter was 15 percent of the former, i.e., the offset of benefits to the loss in payrolls was 15 percent. If the same calculation is made of the loss and the offset from September 1948 to February 1950, i.e., from initial peak to trough, a figure of 14.7 percent is obtained.[9]

Although this recession was mild, it gives some clues as to what would happen with a more severe unemployment. In states where the decline of 1948-1949 was relatively severe, unemployment benefits were exhausted and the unemployed were uncompensated or else fell upon general assistance.

Possible insolvency of state systems

The mild recession of 1949 brought up also the related issue of the solvency of a few of the state systems where a heavy flow of benefits threatened to drain away thin reserves. In such a case

[8] The suggestion has been made that benefits grow per recipient as unemployment increases. Bertil Ohlin, *The Problem of Unemployment Stabilization* (New York, Columbia University Press, 1949), p. 85.

[9] The calculations are from an unpublished manuscript by Daniel Creamer of the National Bureau of Economic Research. Labor income originating in government is excluded. Ida C. Merriam, in an unpublished manuscript prepared for the N.B.E.R., calculates the loss of private wages and salaries from October 1948 to May 1950 at $7.2 billion, and unemployment benefits (state, railroad and veterans) at $3.2 billion. But some of the benefit payments would have been paid even if wages and salaries had not decreased. A calculation of the "additional" benefits resulting from the decline in employment yields the conclusion that one fifth of loss in wages and salaries was compensated.

the flow of benefits would stop, and, at the same time, the contribution rate would be jumped to 2.7 percent. In other states the flow would shrink after a few months, even if unemployment continued, because benefit rights would become exhausted. A few schemes to avert insolvency and suspension of benefits have been considered by Congress. In 1944, fearing postwar unemployment, Congress offered federal loans to states unable to meet benefit payments, but when the fears were not borne out, this was allowed to expire in 1951. Currently proposals for grants or loans are before the Congress, but the relief is limited, and, to secure it, a state would have to raise its contribution rate to the maximum. The states which have ample reserves—and this is the situation of most—fear that federal help for the weak systems may be a step toward federalization of unemployment insurance; the Congress, heeding this attitude and mindful also that assistance to some may be discrimination against others, prefers to temporize. The likelihood is that reform will wait upon depression.

Unemployment compensation does, then, provide a first-line defense against moderate recession, although it will not stand up against depression. Contributions as an *aggregate* do rise in good times and shrink in bad because of the rise and fall of payrolls—the base of the tax. But this desirable swing is restrained by the perverse performance of the *rate*. The only modification actually in operation is in Arizona where an approximately level average rate (1.3 percent) has been calculated which, over a period of 7-10 years, should maintain the reserve fund at an adequate level, supposing some years to be good and some bad.[10]

Countercyclical rate variation

Complete acceptance of fiscal policy considerations would indicate reduction, or even complete suspension, of the tax in recession with reimposition in prosperity of a rate sufficient to restore reserves to the desirable level.[11] Adoption of such a program would require federalization, and even then it would raise technical questions to which neither theory nor experience pro-

[10] Merriam, *Social Security Financing*, *op. cit.*, p. 78.

[11] At present in a prosperous year collections exceed expenditures by $500 million, and in a year of modest recession expenditures exceed collections by $800 million. The scheme outlined above could easily double each of these figures.

vide easy answers. What criteria for rate change are acceptable and feasible? Should the timing be discretionary or automatic? A discretionary technique would introduce some uncertainty into business planning, while automatic devices would not; but automatic rate changes are inherently arbitrary and require careful selection of the indicators. Administrative difficulties would be slight so long as frequent rate changes are avoided.

A special objection grows out of the view that social insurance should not be tied closely to immediate issues of fiscal policy. An insurance program, it is argued, should look above all else to its financial integrity, and countercycle changes in payroll taxes might impair this goal. The proponent of fiscal policy may answer that the financial integrity of unemployment compensation as an insurance scheme is already in danger, since, in some states, it could not survive a depression and in others it would cut off benefit payments while need for them was great.

11

Public Works

Our long-run objective is to achieve a program of direct Federal and Federally-assisted public works which is planned in advance and synchronized with business conditions. In this way it can make its greatest contribution to general economic stability.—PRESIDENT TRUMAN, STATE OF THE UNION MESSAGE, 1946.

1. INTRODUCTION

Private construction has shown marked cyclical variability; high in good years, it falls away sharply in bad. For decades, economists and public men have felt that the swings in public construction might serve as a partial offset. In 1930-1931 something of this sort was attempted, and, if the downturn had been moderate, the upswing in public construction might have been an adequate corrective. In fact the impact of depression was not moderate, and after 1930-1931 public construction shrank instead of expanding as an offset to the continuing decline in private construction (see Table 6).

The shrinkage in public construction was, however, wholly attributable to state-local and not to federal action. Federal expenditure for new construction expanded markedly during the 1930's in absolute as well as relative amounts. Indeed, if state-local had in 1933 expanded in real terms over the 1927 level relatively as much as did federal, total construction, public and private, would have been 20 percent above the 1927 level, despite a drop in private construction to a sixth of the 1927 level. But state-local ability and willingness to spend dwindled, and this shrinkage would have been even greater except for expansion of

Table 6. NEW CONSTRUCTION OUTLAY, 1928-1953
(in billions of dollars)

Total	*Private*	*Public*		
		Total	*Federal*	*Nonfederal*
1928....11.6	9.2	2.5	.2	2.3
1929....10.8	8.3	2.5	.2	2.3
1930.... 8.7	5.9	2.9	.3	2.6
1931.... 6.4	3.8	2.7	.5	2.2
1932.... 3.5	1.7	1.9	.4	1.5
1933.... 2.9	1.2	1.7	.8	.9
1934.... 3.7	1.5	2.2	1.3	.9
1935.... 4.2	2.0	2.2	1.3	.9
1936.... 6.5	3.0	3.5	2.3	1.2
1937.... 7.0	3.9	3.1	1.8	1.3
1938.... 7.0	3.7	3.4	2.0	1.4
1939.... 8.2	4.4	3.8	2.1	1.7
1940.... 8.7	5.1	3.6	2.1	1.5
1941....12.0	6.2	5.8	4.4	1.4
1942....14.1	3.4	10.7	9.7	1.0
1943.... 8.3	2.0	6.3	5.8	.5
1944.... 5.3	2.2	3.1	2.6	.5
1945.... 5.6	3.2	2.4	1.8	.6
1946....12.0	9.6	2.4	1.1	1.3
1947....16.7	13.3	3.4	1.2	2.2
1948....21.7	16.9	4.8	1.6	3.2
1949....22.8	16.4	6.4	1.9	4.5
1950....28.5	21.5	7.0	2.1	4.9
1951....30.9	21.6	9.3	3.4	5.9
1952....32.6	21.8	10.8	4.8	6.0
1953....34.8	23.6	11.2	..	..

Source: U.S. Department of Commerce, *Construction, Building Materials, Statistical Supplement* (Washington, May 1953).
Detail may not add to totals because of rounding.

federal grants which induced some public works spending by state-local governments. Federal grants 1936-1939 were eleven times greater than those 1926-1929, mostly because of the emergency agencies, Public Works Administration (PWA) and Works

Progress Administration (WPA). There was, besides, an equal relative expansion in the area of direct federal expenditure for its own projects. Total federal expenditure for new public construction, which ran at an annual rate of $200 million 1926-1929, was $2,100 million 1936-1939.[1]

Present public construction expenditure

The war years brought a vast increase in direct federal construction, a decline in grants, and a decline in nonfederal construction. Since then the grant program has been revised and now covers four main purposes: highways, airports, hospitals, and housing. In calendar 1952 grants were about $619 million with those for highways accounting for 80 percent. Nonfederal construction not receiving grants has grown greatly, and so have direct federal projects. In spite of the rapid postwar rise of spending on public construction, a very large backlog of desirable projects exists, amounting to tens of billions of dollars.[2]

The experience of the 1930's and 1940's offers guidance concerning countercyclical use of public works. When confronted by a severe depression, state-local governments as a whole have not the ability to expand such spending. The few that are strong enough tend to hold back because expansion by them can affect the level of income and employment within their own boundaries to only a limited degree. Financial assistance from the federal government by grants and loans would be a necessary and desirable method for getting concerted action by all levels of government. In order to secure reasonably prompt action, advance planning of a very specific sort is essential, especially for state-local works. Many state and local governments do not have, and do not know how to prepare, important information concerning the legal, engineering, and financial aspects of projects. A reservoir of state-local projects of tested value is unlikely to be created and maintained without continuous federal leadership. The initiative in framing a public works program for all levels of government must be federal: it alone can take an over-all view, it alone has the financial resources, and it alone, rather than

[1] Much of the material which follows is derived from Chapter 4 of my book *Federal Grants and the Business Cycle* (New York, National Bureau of Economic Research, 1952).

[2] *Economic Report of the President* (January 1954), pp. 104-5.

any other level of government, is responsible for attempts to moderate cyclical swings. The Task Force Report on Public Works of the Hoover Commission stated that "the advance planning and promotion of public works . . . should be recognized as a continued responsibility of the Federal government, working in cooperation with States and municipalities."[3]

2. FEDERAL GRANTS

In terms both of precedent and promise the grant-in-aid is an acceptable and effective lever to enlarge federal cyclical control over state-local expenditure for construction. The grants might be of two types: grants for planning and grants for state-local projects of every type when these had been planned and cleared in advance.

Grants for planning

The federal government has already recognized the wisdom of advance planning of a shelf or reserve of projects by offering, 1945-1950, repayable advances to state and local governments. At present, however, this program is inoperative. It should be revived and made more generous. Since the emphasis of such a program would lie not simply in encouraging planning but in planning deferrable projects, outright grants rather than repayable advances might be offered to cover part (perhaps half) of the planning cost of approved projects so clasisfied, while repayable advances might be offered for other acceptable projects.

Variable construction grants

Success in extensive advance planning and selection of deferrable projects would, of course, not necessarily induce state-local governments to enlarge and accelerate their public works spending with recession and to curtail and retard it with prosperity. For those purposes a federal grant program covering the whole area of state-local construction is necessary. Both the total amount and the percentage of the cost of projects offered as grants to state-local governments might be varied yearly. Let us suppose Congress set up a public works administrator with authority to

[3] Task Force Report on Public Works, Appendix Q, p. 4.

use the level of private construction as the chief guide to policy decisions concerning grants. When the level was high, the percentage of the cost of approved state-local projects assumed as grants would be low; when the level was low, grants would be larger. The administrator, either by authority or by Congressional instruction, might specify that for the year ahead, expected to be a year of high employment, the level of new private construction would be $22 billion and the appropriate rate for federal grants be 10 percent. Unless this yearly level of private construction fell off more than $4 billion, 18 percent, the 10 percent rate would be held. If the yearly level of private construction declined

Table 7. ILLUSTRATIVE INVERSE VARIATION OF GRANTS WITH THE LEVEL OF PRIVATE CONSTRUCTION

Level of Private Construction (billion $)	*Rate of Federal Grant (percent)*
Above 18	10
13 and under 18	50
Under 13	60

below $18 billion, grants would be at the rate of 50 percent, and if below $13 billion at the rate of 60 percent. The range in percentages, from 10 to 60, is wide because of the assumption that the federal government should be generous in depression and niggardly in prosperity.

Grant expansion undesirable in mild recession

The level of private construction might be allowed to fall 18-20 percent before specifying any increase in grant, and therefore in spending for public works, on the premise that such spending should not be responsive to mild downturns in private construction. In the first place, a mild downturn may reverse itself within a short period. Prompt acceleration of spending would in this case not serve a countercyclical purpose and might be inflationary. In the second place, construction costs are somewhat rigid against decline. Prompt acceleration of public construction, following a mild decline in private, would reduce the pressure toward a fall in costs.

It is, of course, possible that delay in accelerating public works might not avert bad timing, since an upturn in private construction might still coincide with the acceleration. But delay until the decline in private construction had been appreciable would reduce the possibility of this eventuality, and even if private construction did revive, the ground to be made up because of the delay might be sufficient so that the inflationary effect would be unimportant. The difficulty of bad timing could, moreover, be minimized by concentrating on small projects at the start. If private construction continued to drop, the public authorities could push large projects of long duration with more confidence. But if private construction recovered, construction of small public projects would soon cease.

But once settled upon, it should be prompt

Once a decision to accelerate public works has been taken, it should promptly be made effective. This is the purpose of advance planning. The same purpose is served by delaying acceleration until after an appreciable fall in private construction. A lag in initiation should give time to round out plans for action—in brief, to conclude all preliminary moves short of letting contracts.

An arithmetical example

Let us return to the example given above and work out the possible effects upon the level of total construction. Assumptions must be made about the levels of federal and state-local construction at the start, and of their responsiveness to a policy of acceleration. Suppose the level of new public construction in a year of high employment to be $5.5 billion, of which 30 percent is federal and 70 percent nonfederal. The prospect for increase with depression would, of course, be improved if public construction had been retarded in prosperity. Let us assume that, when private construction fell below $18 billion, public construction could be increased twofold in one and a half years and threefold in two years. The total spent as grants would grow from $385 million to $2,750 and $6,930 million; the level of total construction would move from $27,500 to $28,900 and $29,400 million. (See Table 8.)

How could existing grant programs, notably the program for highways with a federal share of 50 percent, be fitted into the

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Table 8. HYPOTHETICAL VARIATIONS IN LEVEL OF PUBLIC CONSTRUCTION AND FEDERAL GRANTS FROM PROSPERITY TO DEPRESSION

Level of Construction
(millions of dollars)

Year	*Private*	*Public*					*Total*	*Federal Grants*	
		By Ownership			*By Source of Funds*				
		Total	*Federal*	*Non-federal*	*Federal*	*Non-federal*	*Total*	*%*	*$*
0 (high employment)	22,000	5,500	1,650	3,850	2,035	2,465	27,500	10	385
1½ (depression)	17,900	11,000	3,300	7,700	7,150	3,850	28,900	50	3,850
2 (depression)	12,900	16,500	4,950	11,550	11,880	4,620	29,400	60	6,930

scheme? If, at some future time, the program of aid for highways was being enlarged, an opportunity for merger into a variable grant plan would be presented. Otherwise integration that entailed loss of a 50-percent grant would encounter opposition. Indeed, officials connected with existing programs cannot be expected to favor a plan that would, in good years, reduce their grants to 10 percent.

A modification, altering the *status quo* less, would convert the plan into one for emergencies. In bad years grants on a liberal basis might be offered for construction not now receiving aid, and supplementary grants might be offered for existing programs. Logically this plan would, when economic conditions improved, call for discontinuing the former and reverting for the latter. The defects of such an emergency scheme are that the complete obliteration of working administrative contacts in good years would place impediments in the way of quick action in emergencies, and that maximum countercyclical leverage requires complete rather than partial coverage of state and local construction. A late start in providing grants would increase the danger of bad timing because once projects had become eligible for higher percentage grants, the higher percentage should usually hold until completion of the projects.

The grants suggested above would fluctuate cyclically, but at any point of time the federal percentage would be uniform for all states. In allocating the grants geographically account should be taken of state need for projects in order to set limits on the aggregate of annual grants that might go to each state. Measures of need would be rough. For example, a state with a large area and small population needs more rural highway mileage per capita and requires larger highway expenditures per capita than one in the opposite situation; a state with a large urban population has more need for sewage disposal facilities than one with a large rural population. Precise measures of need are not necessary, and reliance on such criteria as total population, urban population, and area would serve for most purposes.

The above scheme could be set up by Congress on a formula basis so that its administrator would have fairly precise and objective criteria as to timing, grants, etc. In such case Congress would logically vote a continuing appropriation and forego,

within broad limits, its yearly right to fix the amount to be spent. Or Congress could merely specify that certain criteria or indicators should guide, rather than determine, the operation of the program. Wide discretionary power here would probably be unwise. Certainly experience with FERA and WPA during the 1930's indicates this conclusion.[4] If, as is proposed, the scheme is set up in advance of depression, an administrator should be given legislative protection against pressures through Congressional specification of objective criteria for his guidance. *Some* administrative discretion, and *some* objective determinants of federal action must be compounded into a workable program.

Authority to lend

Another element that logically seems to belong in a coordinated public works scheme is federal power to lend to state and local governments. When state and local governments are unwilling or unable to provide their share of the expenditure, the federal government might wish to make it easy and attractive for them to borrow in depression. The tax sources of most local governments and of some state governments are quite inelastic; their ability to borrow in the market may be limited by statutory restrictions and by the difficulty of getting reasonable terms. Net borrowing of state-local governments was a negative amount 1933-1938. Private lenders in depression are deterred by the risk of loss and lack of liquidity. The merits of lending to state and local governments for the sake of increasing employment are not their affair. Yet, as the experience of PWA shows, loans of this sort may be "safe" if marketability after the depression is the test. Another reason a federal public works agency might want the power to lend is that loans are likely to be expansionary.[5] If state and local

[4] James A. Maxwell, *The Fiscal Impact of Federalism in the United States* (Cambridge, Harvard University Press, 1946), pp. 153-58.

[5] Benjamin Higgins has pointed out that "fiscal timing" of public works, shifting the proportion financed by current revenues, is more flexible than physical timing (*Public Investment and Full Employment*, Montreal, International Labour Office, 1946, p. 47). With the present high built-in flexibility of federal revenues the shift from an over-all surplus to a deficit and vice versa will be almost automatic; therefore no special steps seem necessary to make "fiscal timing" effective for federal public works. But for state and local governments, built-in flexibility is much less (short of a very serious depression that brought a vast growth of tax delinquency); moreover, they appear to be more likely than the federal government to enact new levies in depression.

governments in depression secure their share of construction expenditure by increased taxation, especially by taxing consumption, the net effect of the grant scheme on the economy might be income-decreasing.[6] The spread of commodity taxes in the 1930's indicates that some of the expansionary effect of increased spending was thereby drained away. In short, a scheme is indicated by which, in depression, grants are supplemented by loans from the federal government. In prosperity, on the other hand, no new loans would be extended, and the lending agency might sell its assets to private investors.

3. *FEDERAL CREDIT AGENCIES*

In the years since 1945 the federal government, through government corporations and credit agencies, has given a vast stimulus to construction. Outstanding loans receivable of such corporations and agencies more than doubled 1946-1952; the amount (excluding foreign) was $4.3 billion for 1946 and $10.1 billion for 1952.[7] But these figures do not indicate the full impact upon the economy of federal credit programs because insurance and guarantees of private loans have predominated rather than direct loans. At the end of fiscal 1953 direct loans and investments (excluding foreign) were $8,738 million, while guarantees and insurance were $35,000 million, a total of $43,738 million.[8] The most important use of these programs has been to aid residential housing. In 1953 the federal government had contingent liabilities, by way of Federal Housing Administration insurance and Veterans' Administration guaranty, of $25 billion, which is about 40 percent of residential mortgage debt. These programs have been so generous that room for further liberalization in recession is limited.[9] The postwar need for housing was real, but it seems

[6] Loans are likely to be expansionary because in depression purchases of government securities are likely to be made from savings or through monetary expansion. On the other hand, an expansion of construction expenditure financed by taxes on consumption may, by restricting consumption, neutralize or more than neutralize the stimulative effect of the increased government spending.

[7] *Federal Reserve Bulletin*, May 1953.

[8] Budget of the United States Government for fiscal 1955, Analysis E.

[9] See Leo Grebler, *The Role of Federal Credit Aids in Residential Construction* (New York, 1953), National Bureau of Economic Research, Occasional Paper 39, p. 5, for an earlier figure.

clear that the federal government underwrote injection of credit which secured labor and material by a process of bidding them away from other uses. In short, these activities were inflationary. If, in the future, public works are used countercyclically, steps must be taken to see that federal credit programs do not work at cross-purposes. To this end the recommendation, made in the 1954 Economic Report, that the President be given power "to make permissive adjustments in the conditions on which credits may be insured or guaranteed" is excellent. Variation of the down-payment requirement, the repayment period, interest rates, and maximum loan-value ratios would strike at specific features where borrowers are sensitive. But countercyclical exercise of such powers will require courage because the trend appears to be toward the social objective of providing a large volume of housing construction at all times. In this event a recession may bring direct federal entry on a large scale into the field of public housing.

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12

Individual Income Tax

1. PRESENT FEATURES

This tax has obvious merits as an instrument for fiscal policy. Its incidence is predictable and so, therefore, are its effects upon the aggregate of disposable income; rate changes, at least at the bottom of the scale, seem unlikely to have a disturbing effect on business decisions; the amount of collections through it are large and current.

Yield, rates, and exemption

The individual income tax is the largest single revenue producer in the federal system, yielding in fiscal 1953 $32.5 billion of total receipts of $64.6 billion. Rates begin at 22.2 percent on surtax net income in the first bracket $0-2,000, they reach 53 percent for single persons in the bracket $14,000-16,000, and rise to a maximum of 92 percent on the excess above $200,000. The level of the personal exemption is $600, and the tax is collected by a system of voluntary assessments, supplemented by witholding on wages and salaries, and a limited amount of information at source.

Base of tax

The estimated total of surtax net income for calendar 1951 was $99.9 billion. This is the base of the tax and it corresponds to the older and more familiar concept of taxable net income. This base is equal in size to about 45 percent of total income receipts by individuals, the difference being attributable to two sets of facts: (1) The concept of income for tax purposes and for the purposes of national income accounting is different. Personal

income as reckoned by the Department of Commerce includes the rental value of owner-occupied homes, some imputed interest, the value of food produced and consumed by farmers, income in kind of wage earners—all of which are *not* regarded as income for tax purposes. (2) The federal income tax has always taken account of costs in acquiring income and of individual needs (a) by allowing as deductions from gross income certain expenses or costs and (b) by granting personal exemptions and credits which vary according to family status. Tax computations start with "adjusted gross income" which is money income *minus* allowable expenses incurred in earning income. But from this figure the taxpayer can subtract *personal* deductions for state and local taxes, contributions (within limits) of designated types, medical expenses (within limits), personal interest, net losses from fire, theft, storm, etc. For 1951 these amounted to about $21 billion. The taxpayer can subtract also his personal exemptions which, at $600 per capita, totaled over $62 billion.

Base and tax collections affected by changes in personal exemption

While debate goes on concerning enlargement or reduction of the tax base by restricting the deduction of interest on personal indebtedness, by enlarging the scope of medical expenses, by adding some income received in kind, such changes appear to have no merit as instruments for fiscal policy. For its purposes the significant method of altering the tax base is the per-capita exemption.

From 1913 to 1943 the individual income tax allowed two levels of personal exemption—one for a married couple and one for a single person—and also a so-called credit for dependents. In 1943 the figure for a single person was $500, for a married couple $1,200, and $350 for each dependent. Then in 1944 a uniform per-capita exemption of $500 was established, raised to $600 in 1948. The administrative convenience of a single figure is obviously great; and this relative simplicity means that more flexibility for fiscal policy is possible, through variation of the exemption, than was the case before 1944. The magnitude of changes in the tax base and in revenue collections to be achieved through alteration of the exemption is astonishing. In 1948, for example,

the increase of $100 brought a revenue loss of $1.7 billion and decreased by 6,000,000 the number of taxable returns. At present an increase from $600 to $700 would bring a revenue loss of $2.5-3 billion. This takes place not merely because of the concentration of income and of number of taxpayers at the bottom of the scale, but also because an increase (or decrease) applies to every taxable return. A slice is cut off (or added to) the tax base from the bottom to the top. Still another reason for the great revenue effect is the progressivity of the rates. An increase of $100 in personal exemption cuts away net taxable income in the highest bracket in which a taxpayer has net taxable income. The revenue loss from giving an additional exemption of $100 to the person subject to the top rate of 92 percent is, therefore, $92.[1]

Importance of the first bracket

A further important fact for fiscal policy is the size of surtax net income in the first bracket, together with the rate applied to this first bracket. For calendar 1952 the total of surtax net income was estimated at $96.6 billion, of which $4.5 billion fell in the adjusted gross income bracket below $2,000.[2] But the first bracket rate applied also to the first $2,000 of surtax net income for returns in all brackets, and the total surtax net income to which the beginning rate—22.2 percent—applied was estimated at $67.3 billion. The beginning rate, therefore, produced tax liabilities of $14.9 billion, which was nearly 60 percent of the estimated total. A change in the first bracket rate of 1 percent would produce more revenue than a change of 15 points in the rate applied to surtax net income of $20,000 and over. The amount of surtax net income taxed at the first bracket rate is relatively stable. A fall or rise in incomes produced by depression or boom will have a small effect on the first $2,000 of surtax net income; it will, however, have a marked effect on the amount of surtax net income in the higher brackets.

[1] Since about 120,000,000 exemptions are claimed, addition of $100 would appear to remove $12 billion from the tax base. But some of this—perhaps 5 percent—would not be used. Applying the beginning rate of 22.2 percent to the remainder gives a revenue loss of $2.5 billion to which some further loss arising out of progression should be added.

[2] Summary of the Provisions of the Revenue Act of 1951, prepared by the Staff of the Joint Committee on Internal Revenue Taxation, p. 7.

Withholding and declaration

World War II brought a tenfold increase in the number of taxpayers and a trebling in the size of the tax base; it also brought reintroduction of witholding and the innovation of declarations of estimated income with current payments of the amount by which the estimated tax exceeded withholding. At present nearly two thirds of total tax liabilities under the individual income tax are withheld—in 1949, $9.6 billion of tax liabilities of $14.5 billion. This withheld amount forms no part of take-home pay. Somewhat less than half as much—$4.7 billion in 1949—is estimated as a tax liability by declarations, and this is paid quarterly. These two devices, by making tax payment current, mean that changes in income up and down are promptly reflected in payments.[3] Before the reintroduction of withholding (and declaration) a rise or fall in taxable incomes would be reflected in tax receipts with a lag. The current tax liability of a person whose income had fallen would depend upon his taxable income of a year earlier, and, for this reason, his disposable income would be reduced to a greater extent than if tax payments were current. A person whose income had risen would, on the contrary, find his disposable income more than under a current plan. The older system, therefore, exaggerated the fall and the rise of disposable incomes in depression and in boom; it reduced the built-in flexibility of the income tax.

The built-in flexibility and elasticity of the current individual income tax stem from (a) the relative volatility in the tax base, i.e., taxable net income, and (b) the progressive rates.

Volatility of base increases flexibility

The absolute amount of adjusted gross income which does not enter the tax base, i.e., the absolute amount of exemptions and deductions, is relatively stable. When, as at present, the amount

[3] While declarations make payments more current than the pre-1944 system, they are not as current as withholdings. Declarations are made say in March. If estimated income of the year in question changes, the declaration need not be changed until the next January-March. People who pay under declaration are, however, more likely to make some modification of their financial behavior as a result of changes in income than are people subject only to withholding.

of the per-capita exemption is low, the total of exemptions against taxable returns is not very sensitive to business conditions. *Some* elements in deductions are volatile, but such large items as contributions, taxes paid to state and local governments, medical expenses are not. As a result *taxable* net income is relatively volatile. For example, if adjusted gross income is $1,000 and deductions and exemptions are $700, then the tax base is $300. If now adjusted gross income falls to $900, while deductions and exemptions remain the same, the base will fall to $200. In short, the tax base has fallen by one third in response to a fall of one tenth in adjusted gross income.

The tax base is, however, not uniform in its volatility. That portion which falls in the adjusted gross income classes under $5,000 is relatively stable; the higher portions, containing a substantial amount of dividends, net profits from partnerships and from business and professions, are volatile.

Progression increases flexibility

The built-in flexibility and elasticity of the individual income tax depend not only upon the tax base, but also upon the fact of a scale of progressive rates. When personal incomes increase, part or all of the increase will become taxable at a *higher rate;* and conversely, decrease will bring a lower rate. For example, in 1952 a married couple with two dependents and a net income (after deductions but before exemptions) of $3,000 would pay $142 in tax—an effective rate of 4.4 percent; with a net income of $5,000 the couple would pay $575—an effective rate of 11.5 percent. The effect in the aggregate is that a decline in incomes will bring a decline in collections which is more than in proportion, and that the decline in *disposable* incomes is *less* than in proportion. A rise in incomes brings the opposite effect: the increase in tax collections will be more than in proportion, and the rise of disposable incomes will, therefore, not be proportionate to the rise in personal incomes.

An illustration

A simple example will indicate the effect of progression. Suppose three individuals with net incomes before exemption of $1,000, $1,500, and $2,000 paying effective rates of 8 percent,

12 percent, and 14 percent, and therefore a tax of $80, $180, and $280. Since their total net income is $4,500 and total tax $540, a *proportional* tax rate of 12 percent would bring the same yield. Suppose next that each individual suffers a fall in net income which places him a step down so that C who had a net income of $2,000 now has $1,500 and pays $180, B who had $1,500 now has $1,000 and pays $80, and A who had $1,000 now has $500 and pays $40. The aggregate shrinkages are as follows:

> Net income from $4,500 to 3,000, i.e., by 33.33 percent.
> Tax revenue from $540 to 300, i.e., by 44.44 percent.

But if the tax had been levied at a proportional rate of 12 percent, the tax shrinkage would have been $540 to $360, i.e., by 33.33 percent. Thus one quarter of this tax shrinkage is due to progression.[4]

The built-in flexibility of the individual income tax may well be .2 and elasticity may be 2.5. If personal income fell by 10 percent from $270 billion to $243 billion, the yield of the tax might fall by 25 percent from say $22.0 billion to $16.5 billion; a rise from $270 billion to $297 billion might raise the yield to $27.5 billion.[5]

[4] Richard E. Slitor reckons the built-in flexibility of the 1945 individual income tax over most of the income range as "between thirty and sixty per cent higher than it would be if the income tax were merely proportional." "The Measurement of Progressivity and Built-in Flexibility," *Quarterly Journal of Economics* (February 1948), p. 313.

In an unpublished manuscript Daniel Creamer of the National Bureau of Economic Research has attempted to measure the offset to the loss of disposable income attributable to the progressivity feature of the tax. For the contraction period 1948-1949, 43 percent was so to be attributed.

[5] Where T and Y are respectively tax yield and personal income. Joseph A. Peckman, in a careful and instructive article, secures a value of .19 for built-in flexibility, using adjusted gross income, rather than personal income, as the base. "Yield of the Individual Income Tax During a Recession," *National Tax Journal* (March 1954), p. 2. R. A. Musgrave, writing in 1945, gave the following estimates:

GNP	*Yield of Personal Income Tax*
82	60
100	100
118	140

Federal Tax Reform in Postwar Economic Studies, No. 3 (Washington, Board of Governors of the Federal Reserve System, 1945), pp. 41-42.

It follows from the argument given above that a higher exemption and steeper progression would improve the built-in flexibility of the individual income tax. The per-capita exemption of $600 in real terms is the lowest in the history of the tax and a higher exemption has considerable political appeal. Congress might also increase progression by lowering rates in the bottom brackets. Both of these steps would bring a large loss in revenue not easily recovered by higher rates on the upper brackets. For 1952 surtax net income above $25,000 was estimated at $13.8 billion of which $6.7 billion was taken as taxes, leaving $7.1 billion. If all of this remainder were taken by higher rates, and distributed downward, the tax reduction per taxable return would be only $162. Achievement of steeper progression, supposing the total yield of the tax is to be maintained, would not be easy at present.

Two minor steps to increase built-in flexibility of the individual income tax may be mentioned. One is to allow the taxpayer to carry back unused personal exemption. A person with zero net income in one year who, therefore, did not use his exemption, could be allowed to carry back this unused amount to secure a refund of the tax paid the year before when he had a net taxable income.[6] The effects for fiscal policy would be similar to those secured for the corporation income tax (where a fuller discussion is given). Quantitatively, however, they would be of slight importance so long as the personal exemption is low. Another step would be to expedite refunds in depression and slow them up in boom, but this would be arbitrary and indefensible.[7]

[6] This is a form of averaging of income. Most averaging schemes either are neutral or perverse, in terms of built-in flexibility. Richard E. Slitor, "The Flexibility of Income Tax Yield under Averaging," *Journal of Political Economy* (1946), p. 266.

[7] Carl Shoup points out that the rule that refunds of overpayment cannot be applied for until January 1 of the year subsequent brings unfortunate effects in recession. A worker who lost his job in July, and remained unemployed, would have had more taxes withheld during the first six months than would be due for the year as a whole. The case of persons who had filed declarations would be similar. Allowance of earlier (tentative) refunds would be a remedy, but this would be a difficult administrative task. Max F. Millikan (ed.), *Income Stabilization for a Developing Democracy* (New Haven, Yale University Press, 1953), p. 285.

2. EFFECT ON CONSUMPTION, SAVING, AND INVESTMENT

The assumptions

Analysis of the effects of the individual income tax upon consumption, saving, and investment rests upon the premise that the tax is not shifted—that its effect is to reduce individual incomes. The average propensity to consume is supposed to be high for low, and low for high, incomes. Low exemptions and high tax rates on low incomes will reduce consumption, whereas steep progression will reduce savings. Selection of a scale of rates should, therefore, depend somewhat upon how it is intended to affect consumption and saving.

Early writing about fiscal policy was slanted strongly toward the thesis that the tax system should bear lightly upon consumption and heavily upon saving. In part this rested upon a desire for redistribution for its own sake; in part upon the premise that savings tended to outstrip investment outlets, and that, unless this were halted, the excess of saving would be wasted and the economy would, even in equilibrium, have unnecessary unemployment. Absorption of the excess, together with lower taxes on consumption, would induce an increase in consumption and push the economy toward full employment.

Steeper progression little effect on consumption

This thesis no longer enjoys its original popularity. For one thing, it seems clear that the increase in consumption to be secured via steeper income tax progression is very small. Musgrave and Painter have shown that by shifting from 1946 rates to what they call "maximum progression"—a theoretical limit far beyond what is practicable[8]—would increase consumption by less than 3 percent. The reasons are: (1) the tax scale is already steeply progressive, (2) the bulk of taxable income is in the middle and lower brackets, (3) the effects of redistributive changes

[8] It is a 100-percent rate on family incomes above a certain level—$4,900 for one set of assumptions and $7,600 in another. R. A. Musgrave and M. A. Painter, "The Impact of Alternative Tax Structures on Personal Consumption and Saving," *Quarterly Journal of Economics* (August 1948), p. 478.

on consumption depend upon the marginal rather than the average propensity and, while the latter falls off quite sharply as individual incomes rise, the former does not.[9] It follows, conversely, that a less progressive scale *would* have a substantial effect in increasing the burden on consumption.

A shortage of savings

The older thesis concerning the danger of oversaving has also lost ground. The elasticity of investment opportunities postwar has been great, with a shortage of saving. Moreover, the effectiveness of increased investment in enlarging output came to be reappreciated. Thus discussion has turned toward removal of tax deterrents to investment and saving, and this has brought under scrutiny the very high tax rates on large incomes.

It seems, indeed, that the top rates of the individual income tax, unless viewed as a method of redistribution or of curtailing saving, have little use. For example, in 1951 the estimated amount of surtax net income in the brackets $100,000 and over was $591 million, on which the estimated tax was $533 million, or 90 percent.[10] Application of a rate of 60 percent would reduce revenue only by $178 million. In such case, possibly much of this amount would be saved, and certainly this is the type of saving which should be put into risky investments. To a lessening degree a similar argument can be made as we go down the scale. So long as investment outlets are abundant and savings are not, the case for moderating progression is persuasive.[11]

[9] High-income families may, on the average, use a smaller percentage of their income for consumption than do low-income families. But this generalization is not inconsistent with equal *marginal* propensities to consume. A family with an income of $4,000 might respond to an increase of income to $4,500 by increasing consumption to $4,450. That is, its marginal propensity would be 90 percent. If the $500 gain of this family had been taken through taxes from a family with an income of $8,000, this latter family might *reduce* its consumption by $450. The total consumption of the two families would be unaffected by the redistribution.

[10] 82d Congress, 1st Sess., Ways and Means Committee, Revenue Revision of 1951, *Hearings*, Part 1, p. 25.

[11] Senator Ralph E. Flanders has commented as follows: "If a man in the $50,000 bracket puts money into risk investment which is successful and yields as much as 10 percent on the investment, the Government will take half of that, in the form of corporation income taxes, leaving 5 percent tax free. It would be unwise for the business to pay out more than half of that in dividends. The investor therefore might receive 2½ percent on his investment

3. RATE CHANGES

Whatever may be the appropriate scale of tax rates to facilitate the best division of the disposable incomes of individuals between consumption and savings over the long pull and in a normal year, what variation in this scale is indicated by depression and boom?

Stimulus to spending from higher personal exemption

In depression investment runs at a low level because the existing supply of capital equipment and inventory seems to be more than adequate to meet current demands upon it for consumer goods and still more for producer goods. Additional investment, if it is to occur, may need to be induced by a growth in consumption or assurance against its further decline. At such a time, the case for a stimulus to consumption is strong, and, if the individual income tax is to be the instrument, this can most readily be done by raising the per-capita exemption and lowering the first bracket rate. Such action has the virtue of being open and dramatic; its effect on individual incomes is obvious. If the public became aware of the purpose of the reduction, and had some experience with it, the sensitivity of the response would increase. Some people will regard the tax cut as a windfall and, for this reason, will spend it freely; but most people will probably regard the cut as bringing a simple addition to disposable income, and will use it for consumption or saving depending on their propensities. In the circumstances assumed, marginal propensities to consume can reasonably be regarded as high, which means that the leakage will be small.

Timing affects leakage

Leakage will, of course, be affected by the timing of the cut within the depression period. Made early, the cut would swell

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but, since this is an addition to his top bracket, the Government will take 75 percent of this, leaving him only five-eighths of 1 percent as a return for his investment in the future of the country. He would not be justified in making such an investment and will naturally prefer tax-free State and municipal bonds yielding a clear 2½ percent." 82d Congress, 2d Sess., Joint Committee on the Economic Report, Senate *Report* No. 1295, p. 8.

cash balances and have no immediate income-generating effect. But if timed later, it might stimulate an upturn. The difficulty of knowing when is the correct tactical time for action may argue against too early action. Rightly timed, the very *prospect* of a cut may stimulate an increase in spending; income expansion will occur before disposable incomes have actually increased.

Retardation of boom investment

In boom investment will be running at a high level not only because of the high level of consumption, but also because investment will generate a chain of spending. With full utilization of resources, a small growth in over-all demand brings inflation and a need to curb both expansion in consumption and investment. Increase of high bracket rates would diminish saving and might put some damper on investment. But when business expectations are good, funds for investment need not depend upon individual (or corporate) saving; they can be secured from the money market. A severe monetary policy would, however, be a deterrent, and it, together with higher upper bracket rates and higher corporation tax rates, might be effective in checking investment. Indeed, their psychological effect might be to create the expectation that an economic decline was in prospect.

Retardation of boom consumption

A check to consumption could be achieved by reversing the steps suggested to alleviate a depression; that is, the per-capita exemption could be lowered and the rate of the first bracket tax raised. Reasoning about the effect on disposable income would parallel that given earlier—a decrease would be substituted for an increase, with dissaving as the limitation instead of leakage. But probably the stock of assets—cash and securities—held by the lower-bracket taxpayers is not large, so that the amount of a tax increase which is offset by dissaving would be small.

The political obstacle

The difficulty in securing public and Congressional understanding and tolerance of such moves in boom would be great. The budget would presumably be running a surplus and prices

would be rising. Higher taxes, and especially a lower personal exemption, would not be politically attractive. This is merely an illustration—a strong one—of the general proposition that, for political reasons, fiscal policy has a bias. Taxes may be reduced and deficits incurred in depression, but a reverse program may not be pursued in boom. Some writers have suggested that the bias be overcome by use of a formula device which would provide for tax changes in response to changes in objective and predetermined criteria. Congress, if persuaded to enact such a scheme, might leave it in operation over the business cycle even though the results were sometimes unpalatable.

Rate change by formula

The individual income tax is readily adaptable to automatic alteration by formula. Let it be assumed that three rate schedules are set up: (1) a normal schedule appropriate to high employment with a withholding rate of 18 percent, (2) a boom schedule with a withholding rate of 22 percent and the whole scale higher by four points, (3) a depression schedule with a withholding rate of 14 percent and the whole scale lower by four points.[12] Such a setup is merely illustrative, and many variants come to mind. Instead of one boom and one depression scale, it would be possible to have several so that as boom or depression intensified, the addition or subtraction also grew. Congress itself might decide the scale to be in effect at any given period, in which case the three (or more) scales would indicate only an intention to confine change to the alternatives specified. Congress could delegate power to make this decision to some appropriate group, or, by legislation, provide a formula specifying mandatory conditions under which each scale would be put into effect. In this latter case there would be no delay, no debate concerning what was appropriate, no political tug and pull. The very statement of the strict meaning of a mandatory formula suggests that it is unrealistic, but discussion of this simple and rigid case will serve best to bring out the major issues.

[12] Raising or lowering the whole scale is, of course, not a necessary part of the scheme. Indeed, it can be argued that the changes should be graduated so as to steepen the slope in depression and flatten it in boom. A uniform rate addition and subtraction is, however, administratively convenient.

Determination of standard level of income

Suppose somehow that a level of aggregate *personal income* is chosen as appropriate to a normal year. This standard level would itself be variable over time because of growth of the economy, price level changes, etc. But no infringement of the mandate need be involved by this variation since the task of revision could be assigned to a technical staff.

Changes in level geared to rate schedule and period

In the formula legislation Congress would specify the amount of the rise or fall of aggregate personal income which would bring the boom or depression rate schedule into effect, as well as the length of the time period. For example, it might specify a 10-percent rise or fall, maintained for four months. On *administrative* grounds how frequently can a schedule be changed? Most schemes have favored semiannual change.[13] This means that, regardless of the relation of the personal income series to the standard, the tax scale would not be altered more than twice yearly. Assume the announcement dates are set at January 1 and July 1,[14] that half a month is required to handle housekeeping matters such as tax tables, distribution of forms, etc., and that the personal income series (seasonally adjusted) is available with a lag of a month and a half. If, then, the four months January through April showed an average figure at least 10 percent above the standard, the boom schedule would automatically come into operation. For taxpayers subject to withholding, no important

[13] Melvin I. White points out that, if only annual changes are permitted, action might lag substantially. His formula aims, through change in the personal exemption and first-bracket rate, to prevent a decline beyond 10 percent in the aggregate of current personal incomes (excluding transfer payments) from some preceding peak period as the standard or norm. Assuming that the consumption component of private spending alone is responsive to tax reduction, he calculates what might be accomplished. In the depression after 1929 his formula, assuming annual change and an announcement date of February 28, would not have brought a tax cut until February 1931—sixteen months after the end of the peak quarter of August-October 1929. A semiannual change would have reduced the lag to ten months. In 1937-1938 an annual basis would have meant a lag of sixteen months, with the cut coming into operation after recovery had begun. *Personal Income Tax Reduction in a Business Contraction* (New York, Columbia University Press, 1951), pp. 66-67.

[14] Selection of fixed dates for changes is so convenient in terms of administration and of taxpayer reaction as to be almost inevitable.

difficulty appears likely; taxpayers making declarations would have to amend their declarations. For all taxpayers year-end revision would be necessary.

Income vs. employment figures?

Let us take a closer look at some of the details of the above scheme. Personal income is an objective series which reflects accurately over-all economic conditions. The figures are available monthly, with a lag of less than two months, and they are reasonably firm.[15] As value figures, they reflect changes in both prices and employment, and, therefore, signal inflation as well as deflation. But value figures are less reliable in reflecting unemployment because a substantial amount of price change may occur with no close relationship to employment changes. Moreover, a value base or standard which, inevitably, must be recomputed fairly often, seems less objective than, say, unemployment as a percent of the labor force. This greater objectivity of an unemployment series may, however, be spurious. Dispute over which persons should or should not be included in the labor force does occur, and the dispute would be greatly intensified if decisions of fiscal policy hung upon the computation.

Current figures

Use of a series which is approximately current has the great merit of tying action about taxes close to the relevant events. To base a change in tax rates upon what happened a year earlier is to run the risk that economic conditions may be reversing themselves. A tax increase made in the present because of a series indicating boom conditions a year ago would be perverse if the boom had, meanwhile, petered out.

Since tax rate changes probably cannot be made more often than semiannually, a nonsensitive formula should be constructed. This can be achieved by selection of a stable series or by averaging an unstable one, and also by seeing that action follows a *substantial* shift in the series. It is not easy to give a precise meaning to "substantial." A very wide signal range would allow conditions of boom or depression to develop without correction; it would allow semiboom or semidepression to persist for many

[15] Figures of GNP and national income are available only quarterly and are less firm.

months. A very narrow signal range would have the opposite bias.

This cursory statement of the features of a formula scheme may convince some readers of its impracticality. A fullfledged automatic scheme, apart from political objections, would make sense only if much more were known than is known about the operation of the economic system. Congressional delegation of power to act is more plausible, and it should not be beyond the wit of, say, the Joint Economic Committee to devise a framework acceptable to Congress.

Need of quantitative studies

Congress, if requested to delegate its power to make tax changes might well wish to know the extent of our knowledge of the effects of different patterns of action upon important economic variables. Supposing a business recession marked by a fall in income payments of 10 percent, how much of an offset would be provided by an increase in the exemption, a decrease in the first bracket rate, a lowering of the whole scale of rates, or some combination? Quantitative studies have been few and many more are needed. One pioneer study is that by Melvin I. White (referred to above). He concluded that the contribution of built-in flexibility of the individual income tax "would be insufficient to cope with the deflationary pressures that accumulate in more than minor business contractions." Making a range of assumptions about the response of the marginal propensity to consume—but assuming no investment response—to increases in disposable income arising out of tax cuts, he found that manipulation of the exemption *and* the first bracket rate could potentially be quite effective. "Supplemented only by the automatic contribution of other fiscal measures, the potential contribution of these techniques would probably prove sufficient to prevent the recurrence of a major collapse in aggregate income."[16] No similar study of anti-inflationary effects is available.

[16] White, *op. cit.*, p. 16. Joseph A. Peckman has calculated the stabilizing effect during recession of built-in flexibility, exemption changes, and general rate changes (rather than changes in the first bracket rate). His conclusion is: "If incomes decline moderately, the individual income tax can be used to hold the drop in disposable incomes to much smaller proportions. Although built-in flexibility alone would not necessarily be sufficient, it can easily be supplemented by moderate rate and exemption changes." "Yield of the Individual Income Tax During a Recession," *National Tax Journal* (March 1954), p. 14.

13

Corporation Income Tax

> The corporate tax seems to be favorable to consumption and relatively unfavorable to investment. . . . Where there is a choice, shall we seek full employment mainly by attempting to promote consumption or by trying to stimulate private investment?—RICHARD GOODE.[1]

1. INTRODUCTION

Before the Korean war the tax rate on corporate income was 38 percent (24 percent normal and 14 percent surtax); the Revenue Act of 1950 raised the level to 45 percent, and that of 1951 to 52 percent.[2] In 1954 the corporation "normal" tax rate, applying to all taxable profit, was 30 percent; any excess over $25,000 is subject also to a "surtax" of 22 percent. The tax has, therefore, very little progression.

Until recent years the corporation income tax has been looked at with a jaundiced eye by many economists. They regarded it as defective in equity, injurious to investment, uncertain in incidence, and discriminatory in structure (particularly by favoring financing through bonds). Harold M. Groves concluded in 1945 "that there is little, if any, rational basis for an independent corporation tax."[3] Postwar a movement for reform got under way with first place given to its integration with the individual income tax. The movement came to a dead halt when hopes of postwar

[1] Richard Goode, *The Corporation Income Tax* (New York, John Wiley & Sons, 1951), pp. 207, 209.

[2] Besides an excess profits tax, now repealed, was imposed at the rate of 30 percent.

[3] *Postwar Taxation and Economic Progress,* McGraw-Hill, New York, 1946, p. 37.

cuts in taxes were dashed by the need for rearmament. After the outbreak of war in Korea Congress, in search of additional revenue and fearful of inflation, made greater increases in corporation taxes than in any other major source. Direct taxes on corporations were 30 percent of total budget receipts in fiscal 1949 and 34 percent in fiscal 1953. In part this was expediency: the political and administrative difficulties of alternative taxes seemed formidable, even though taxation of corporations must be given a low score as an anti-inflationary measure.

But, meanwhile, the climate of economic opinion had altered. It was argued that, *in aggregate terms,* the corporation income tax was progressive and that this feature was an offset to the admitted fact that it might fall with very unequal weight upon persons with the same total income; that its adverse impact on investment might not be undesirable in a defense economy; that, whatever its defects, the corporation tax was better than commodity taxes. In short, the corporation income tax was called "our second-best tax."[4]

2. *SIGNIFICANCE FOR FISCAL POLICY*

Whatever may be the judgment concerning the long-run place of the corporation income tax in our revenue system, its significance for fiscal policy merits separate appraisal. What is its present contribution, and how can this contribution be improved?

The base provides great built-in flexibility

The built-in flexibility of the tax is great because of the nature of the base. Corporate profits are extremely variable over the business cycle compared with consumption, or aggregate individual incomes, or national income. From 1929 to 1932 corporate profits before tax fell from $9.8 billion to —$3.0 billion; national income from $87.4 billion to $41.7 billion; personal consumption expenditures from $78.8 billion to $49.2 billion. In the mild recession of 1949 corporate profits fell from an annual rate of $34.7 billion in the fourth quarter of 1948 to $25.5 billion in the second quarter of 1949.

This variability is exaggerated by marked changes in the level

[4] Goode, *op. cit.,* p. 217.

of prices because these create *inventory* losses and profits. Most corporations reckon inventory on an original cost basis which means that, in a period of rising prices, inventory profits accrue. These profits are likely to be fictitious since they do not take account of the rise in *replacement* cost. Conversely, in periods of falling prices, fictitious inventory losses accrue since they do not take account of the fall in replacement costs. Whatever the merits or demerits of this system of accounting, it enhances built-in flexibility. Taxable income includes changes in the book value of inventory; the tax base is, therefore, higher in a period of inflation and lower in a period of deflation than it would be if replacement cost were used.

On the other hand, the tax base as now defined permits some smoothing out of yearly profits through carry-back and carry-forward of business losses. This matter will be considered later.

Amount of the flexibility

The extent of the built-in flexibility in the corporation tax may be *roughly* indicated. A 10-percent fall (rise) in the gross national product might well bring a fall (rise) of 30-40 percent in the base of the tax and in tax liability. If gross national product were, say, $350 billion and fell to $315 billion, the yield of the tax would fall from, say, $24 billion to $14.4-16.8 billion.[5] It should, however, be noted that the corporation income tax is not current, being paid the year after the liability occurs. For corporations this lag is less significant than for individuals because corporations tend to set up liquid reserves to meet tax accruals. Their decisions concerning dividends, investment, etc., are, therefore, approximately geared to tax liabilities.[6] In any

[5] This gives a value of .25. R. A. Musgrave, writing in 1945 (Board of Governors of the Federal Reserve System, Postwar Economic Studies, No. 3 p. 42), estimated the built-in flexibility as follows:

Level of Gross National Product	*Yield*
(index numbers)	
82	40
100	100
118	160

[6] In logic, corporations should not object to current payment since their practice has been to adjust as if payments were current. The objection, however, that corporation income is highly variable and thus hard to forecast, remains valid.

case, the Revenue Act of 1950 (Public Law 814, Section 205) provides for a gradual transition from payment in four quarterly installments to payment in two portions at the end of the first and second quarters of the taxable year following the one in which the liability was incurred. The change will be completed by 1956.

Sensitivity of yield to rate changes

For purposes of fiscal policy the built-in flexibility of the corporation income tax is reinforced by the sensitivity of the response to *rate* changes. Within a range of 5 percent above or below present rates, an increase or decrease of 1 percent would alter collections by about $250 million. Higher collections of corporation tax are, however, offset to the extent of 10-15 percent by lower collections of individual income tax arising out of smaller distribution of dividends. Similarly, lower corporation tax collections bring larger distribution of dividends and an increase in collections at the individual level. The implicit assumption made here is that the corporation income tax is proportional—a single flat rate. For practical purposes this is the case, but as has been mentioned, the rate on the first $25,000 of taxable income is 30 percent with a rate of 52 percent on income in excess. Collections at the lower rate in calendar 1952 were only 3 percent of the total.

Effect of tax on savings and investment

Much of the theory of fiscal policy deals with the effect of taxes upon consumption and investment. Because of the relative remoteness of the impact of the corporation income tax on individuals, this type of analysis of it is imprecise. But it seems plausible to believe that the direct effect upon consumption of changes in the tax would be slight. In the first place, a large slice (half) of corporate profits is retained and not distributed to individuals; in the second place, distributed profits go largely to persons in the middle- and upper-income brackets who save rather than consume significant portions of their disposable incomes. It follows, therefore, that the tax strikes at savings. Regardless of the business cycle, those who want a tax policy which favors consumption over savings and investment will urge

large use of the corporation income tax; those who, in the interest of economic progress, favor investment, will want the opposite tactic.[7]

Limited antiinflationary effect

For purposes of fiscal policy, however, the significant question is how the corporation income tax operates in periods of boom and in periods of depression. If, in a period of inflation, the villain is believed to be the "gap" between disposable income of individuals and the supply of goods at current prices, increase of this tax will not be helpful as a curb. But if, in such a period, the difficulty stems from excessive investment, the tax *may* have some merit as an antiinflationary weapon. The key issue concerns the source of the investment funds. If it is retained corporate earnings, then an increase in the tax will bring a direct and obvious decrease in investment. But if the source is external —bank loans, flotation of stocks or bonds—then corporate investment is somewhat divorced[8] from corporate saving, and a large tax liability will not be effective. Which factors will, in fact, be operating at a particular period of inflation cannot be forecast. If a restrictive credit policy curtails access by corporations to outside funds, the corporation tax could check investment and have an antiinflationary effect. On the other hand, an easy credit policy—or a severe one which was ineffective—would allow corporations to finance investment from external funds. At very least, the conclusion is indicated that the corporation tax, despite its high built-in flexibility and the sensitivity of its yield to rate increases, is of limited effect in combating inflation since larger collections will have slight and remote effects on consumption and questionable effects on investment.

Limited antideflationary effect

How might the tax operate in an opposite situation? Will its decrease help to dissipate depression? By reasoning parallel to that just given, the effect of a decrease in stimulating consumption would be slight. Corporations with larger incomes after tax—or with smaller losses—might maintain, but would hardly increase,

[7] The assumption is that the tax is not shifted by a rise in prices.

[8] Not wholly divorced, since sale of the issue might be affected by high rates of corporation tax.

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dividends; and even if they did, the increase in consumption would not be large since presumably the marginal propensities of recipients is low. Would a decrease in the tax stimulate investment? In depression the supply of savings is likely to be in excess of investment and an increase in corporate profits which added to this supply would have little effect—supposing interest rates already to be very low. At best corporations would be put in a better posture for expansion so that improved expectations of profits from increased investment might bring prompt action. Again, therefore, the conclusion is indicated that the high built-in flexibility of the corporation income tax and the sensitivity of its yield to rate decreases have a limited value for fiscal policy.

3. IMPROVEMENT OF THE TAX FOR FISCAL POLICY

Carry-overs

Can the techniques of the corporation income tax be altered so as to improve its effectiveness for fiscal policy? Can new techniques to this end be devised?

Demerits of single-year base

A major consideration here is tax treatment of business losses. When a single year is made the basis for calculation of corporate income or loss, a firm will pay tax in years when it has a profit and no tax when it has a loss. High variability of earnings will, in such case, be a disadvantage. The government takes its slice of earnings for a good year, even though the aggregate profits of the firm over several years may be zero or negative.[9] In such cases the tax is paid from capital. The generalizations may be made that inadequate allowance for loss years puts heavier taxes over a period of time upon firms with variable earnings; it, therefore, penalizes risky enterprises; it handicaps new firms which usually face losses in their early history; it handicaps small firms

[9] "Compare Firm A, which earns $500 in each of two successive years, with Firm B, which loses $1,000 one year and makes $2,000 the next. The two firms realize the same net income over the 24-month period; yet Firm B will be liable for tax on twice as much income as will its consistently profitable rival unless the tax law permits B to carry its loss forward to the succeeding year." Morris Beck, "Carryover of Business Losses," *National Tax Journal* (March 1953), p. 69.

because their income tends to be variable; and, as a result of all of these characteristics, it probably diminishes the total of investment and it makes for instability in business spending, since firms tend "to time their outlays so that the deductions are taken only in years of profit. In years of loss or impending loss, expenditures are held to a minimum because the businessman gets no benefit from the deduction."[10]

History of carry-overs

It is, therefore, ironical to find that in the whole history of the income tax, the law was most narrow and restrictive in its treatment of business losses during the years 1932-1938 when stimulus to investment was very necessary. From 1918 to 1920 corporations were allowed a 1-year carry-forward and 1-year carry-back of losses, i.e., a firm with a net operating loss could apply this loss both to reduce taxable income of the prior year—securing a tax refund—or to reduce the taxable income of the year ahead. From 1921 to 1930 the carry-back was dropped, while the carry-forward was extended to 2 years. In 1931 the carry-forward was restricted to 1 year and then, as has been noticed, from 1932 to 1938 no carry-over was allowed. The motive behind these latter steps was punitive, although ostensibly it was to increase revenue by not permitting firms which moved from loss to profit to reduce their tax base. The perverse effects in terms of fiscal policy are very obvious. The 2-year carry-forward was restored 1939-1941 and a 2-year carry-back was added 1942-1949. In 1950 the carry-back was reduced to one year, while the carry-forward was extended to 5 years. In 1954 a 2-year carry-back was restored. This means that corporations have the right to average earnings over an 8-year period. The tax disadvantages of firms with fluctuating income have, therefore, been markedly reduced.[11]

Why carry-forward is favored

Carry-forward has been favored over carry-back for three main reasons. First, administrative handling is easier since carry-back

[10] *Ibid.*, p. 82.

[11] Morris Beck has examined the proportionate effect of carry-forwards and carry-backs for periods from 1 to 5 years (as well as various combinations). For the years 1933-1938 a carry-forward of 5 years would have offset 76 percent of losses, a carry-back 90 percent. This result, however, arises largely from the "economic characteristic of the period." *Ibid.*, pp. 74-76.

requires reopening of tax returns of prior years. Second, the carry-back is of no use for new firms or for firms which have not yet achieved profits; *per contra* it favors established concerns.[12] Third, carry-forwards serve an expansionary purpose since they give an incentive to bring a firm to a profit-making basis.

For fiscal policy carry-back is superior

In terms of fiscal policy, however, the advantages of carry-back over carry-forward are notable. By carry-back a going concern will, in a depression year, secure cash refunds of taxes paid earlier; and then, when economic recovery comes, it will pay taxes proportional to net earnings with no (or little) offset for prior losses. On the other hand, a going concern—operating under a carry-forward system—will not secure cash refunds in depression. It will bring forward its losses into the recovery years, paying low taxes. While the effect of carry-back is to add to the built-in flexibility of the corporation income tax, that of carry-forward is to decrease it. The cash refunds provided in depression by carry-backs are surely more attractive to a going concern than the promise, provided by carry-forwards, of future tax reduction if profits are earned. And in the light of the above considerations, it is reasonable to assume that carry-backs may tend to stabilize business investment, while carry-forwards may tend to stimulate investment *early* in recovery. These fiscal policy considerations favor a longer carry-back than 1 year.[13]

It should, nonetheless, be realized that here, as often, consid-

[12] Firms undergoing liquidation benefit only from a carry-back.

[13] Morris Beck writes: "Either a carryback or a carryforward tends to stabilize business expenditures insofar as instability stems from fear that deductions will be wasted. But a carryback does the job with greater certainty —by reducing income on which taxes have already been paid. To realize a financial benefit from a carryforward, the businessman incurring a loss must wait until his business again shows a profit. If he is contemplating a large expenditure in a doubtful period, it is more reassuring to know that any loss which develops will bring an immediate refund rather than a tax abatement at some future date.

"As an antidepression measure, a carryback has another important advantage over a carryforward: it provides funds when cash is most needed. Following a downturn in business activity, the businessman may be forced by a shortage of working capital to curtail operations, defer maintenance, and, in the case of corporations, postpone dividends. . . . A carryback acts as a cushion in times of financial adversity." *Op. cit.*, p. 83.

erations of fiscal policy conflict somewhat with longer-run considerations. The carry-back, by allowing firms with persistent losses to prolong their lives, slows up prompt reallocation of resources. The tax refunds received by them may come from revenue paid to the Treasury by profitable and efficient concerns. Again, carry-backs "act as a deterrent to the formation of enterprise"[14] by favoring the established concern, whereas carry-forwards give a stimulus to new firms.

Depreciation allowances

Their purpose

Depreciation allowances are, of course, closely related to the issue of loss carry-overs. The allowances are designed broadly to permit tax-free recovery of invested capital. If, however, a firm is allowed to charge depreciation only against a year's income—as was the case in most of the 1930's—the allowance may be wasted in years when no taxable income exists. In deciding to make an investment a firm must reckon not merely its earnings during its useful life but also the number of loss years that may occur.

Origin of Bulletin F

What has been Treasury practice? Prior to 1934 taxpayers were free to select the period during which physical assets might be written off for tax purposes. But in 1933 the Ways and Means Committee noted that the result was to wipe out the income of many corporations with a consequent decrease in tax receipts. It was prepared to recommend "an arbitrary reduction of 25 percent in the depreciation allowances for a 3-year period,"[15] and yielded only because the Treasury undertook to restrict the amount of the allowances by administrative action. Accordingly, Bulletin F was issued setting forth estimates of the useful life of various assets and putting upon the taxpayer the burden of proof that any estimate was erroneous. The timing of this action was, of course, entirely perverse in its fiscal policy effect and must have been one more deterrent to investment.

14 *Ibid.*, p. 84.

15 73d Congress, 2d Sess., House *Report* No. 704; The Revenue Bill of 1934, p. 8.

Allowances less than amortization rates

Wartime aside, depreciation allowances "seldom exceed the amortization rate assumed by managers in making investment decisions. The indications are that the depreciation period is ordinarily much longer than the firms 'pay-off' period."[16] The corporation tax, therefore, puts a penalty on investment in long-term depreciable assets, and there has been agitation for relaxation by allowing firms to select their own depreciation rates, by permitting accelerated depreciation, etc.[17]

Perverse countercyclical effect of accelerated depreciation

Accelerated depreciation of specified types of investment was allowed in World Wars I and II, and after the Korean war. By it the taxpayer could charge amortization of long-term investment over a period not less than 5 years, and, for assets having a life of *less* than 5 years, shorten the existing period by one half. Accelerated depreciation is a method of tax reduction—the more valuable, the higher the current tax rate in comparison with the subsequent tax rate paid on income produced by the investment after it has been fully depreciated. The gain from concentration of depreciation allowances in a period when tax rates are high is obvious. But two further advantages come from acceleration: (1) it "increases the chances that capital consumption deductions will be taken in full with tax benefit; (2) it provides an earlier receipt of the benefit."[18]

What would be the cycle effect of accelerated depreciation, assuming it to be made a regular part of the tax system? Investment now tends to be made in prosperous years and to be slack in years of depression. Accelerated depreciation would accentuate this swing. When substantial profits were being earned, large depreciation allowances could be charged against them, and this

[16] Goode, *op. cit.*, p. 126.

[17] The legislation of 1954 revising the Internal Revenue Code liberalized depreciation "with respect to both the estimate of useful life of property and the method of allocating the depreciable cost over the years of service." New property acquired or constructed after December 31, 1953, can be written off by the declining balance method at a rate not in excess of twice the straight-line rate. 83d Congress, 2d Sess., House *Report* No. 1337, pp. 22-25.

[18] Machinery and Allied Products Institute, *Amortization of Defense Facilities* (Chicago, 1952), p. 79.

reduction in the tax base would reduce the tax revenue. If the assumption is made that tax *rates* are countercyclical, i.e., high in prosperity and low in depression, a further incentive to concentrate investment in good years would be provided. Conversely, in a slump, when profits were small or negative, the large depreciation allowances could not be absorbed—they would be wasted or carried over. If, as at present, the bias was toward carry-forward, taxable income and tax revenues would be shrunk during the early years of recovery. The conclusion is, then, that accelerated depreciation would tempt firms to concentrate investment when profits were actually or prospectively large, and to run their depreciation accounts so as to postpone and reduce taxes at times when, for cycle purposes, this is not desirable.

Announcement effects

A system by which accelerated depreciation was granted on investment made in depression, and denied to investment made in boom, would appear to be a more effective stabilizing device. This type of shift, however, raises obvious announcement problems, supposing that Congress makes the decision. An indication that more favorable tax treatment was in prospect would halt investment and, if the period of discussion was long drawn out, the economic effect would be most unfortunate. In nations with the parliamentary system this problem is easily overcome by making announcement of such a decision in the budget. Short of defeat of the government this means that the decision becomes effective at once. Our system does not, however, readily allow similar assurance to be offered.

Countercyclical tax-rates and accelerated depreciation conflict

The financial value of accelerated depreciation would depend chiefly on the shortness of the period allowed compared with the normal period. Supposing business was offered a 5-year period for plant and equipment ordinarily depreciable over a 20-year period, and that the amount of such investment was $10 billion a year. The *extra* allowance for the first year would be $1.5 billion. If the effective tax rate were 40 percent, corporate tax liability would be $600 million less. On the other hand, after the 5 years had passed, income earned by the assets would be taxable with no

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depreciation deduction and if, in this period, rates were higher, the Treasury would more than recoup its revenue losses. Since lower tax rates in depression and higher in prosperity are standard theory for fiscal policy, the value of accelerated depreciation may not be reckoned highly by most firms.

Accelerated depreciation with a variable annual allowance

But accelerated depreciation need not take the form illustrated above. It could, as one variant, take the form of a large first-year allowance. Given in a depression year, with carry-over in case a corporation does not have enough earnings to absorb it, this might be attractive; given in a boom year, or continuously, the effect might be perverse. Many possibilities exist, all with the characteristic that the difficult decision will be when to grant and when to terminate the tax favors. Unless the scheme is somehow tied to cyclical conditions, so as to stimulate investment in depression and retard it in boom, the likelihood is that accelerated depreciation will accentuate swings in the volume of investment.

Pre-investment accumulation of tax-free reserves

A more promising scheme would, in effect, permit depreciation in advance of actual expenditure for investment. Firms would be allowed to accumulate a tax-free reserve, perhaps in the form of nonmarketable government securities. The cost of these securities would be a deductible business expense—it would be a deduction allowed *before* being spent instead of the depreciation now allowed *after* expenditure on depreciable assets.[19] The reserve could be freed by the government, through repurchase of the securities, for approved investment in a period of depression, although a firm would be allowed to withdraw its reserve at any time if it paid a tax equal to the previous exemption.[20]

Could the scheme be made attractive enough to induce firms to

[19] A scheme of this sort has been tried in Sweden. See J. P. Shelton and G. Ohlin, "A Swedish Tax Provision for Stabilizing Business Investment," *American Economic Review* (June 1952), pp. 375-79. They state that the reserves are merely of a bookkeeping nature and do not have to be put into government bonds.

[20] See Gustave Simons, "New Techniques for Capital Formation in a Free Enterprise System," *The Conference Board Business Record* (May 1950). Simons regards this scheme as similar in principle to a funded pension trust.

provide a significant volume of reserves? The hitch here would probably be the conditions under which the reserves could be used. If firms were allowed easy withdrawal, the attractions of a reserve would be great; but if government restricted firms to depression use, firms might feel that they were buying a pig in a poke. Even for depression use the government would presumably allow firms to use the special reserves as a substitute for use of depreciation reserves, i.e., to purchase replacement equipment. Undoubtedly many technical and administrative difficulties would emerge in setting up a scheme of this type. Yet it seems to have merit. If in good years firms could be induced in this way to hold back somewhat on investment spending, the major peacetime condition set for later release should be merely the existence of appreciable unemployment.

Under the Swedish scheme a firm when it invests its reserve is not permitted to charge depreciation on the assets so acquired. This reduces markedly the tax reduction which is secured when the reserve is originally established.

Decelerated depreciation

The federal government of Canada in 1951 adopted decelerated depreciation—accelerated in reverse—for the purpose of checking inflation. Depreciation of nonessential assets acquired after April 10, 1951, was deferred. This step discouraged such investment because it delayed tax-free recovery of assets and also moved the tax deduction from years when incomes and tax rates were high to years in which they might well be lower.[21] The device could have considerable power, but for ordinary countercycle purposes it must be ruled out because it requires designation of some types of investment as nonessential. Use of such a direct control is not appropriate to a free-enterprise economy, short of a war-time emergency.

21 The scheme discriminated against certain businesses. The limited time period meant that firms which acted just before the beginning date, and could easily postpone replacement until after the terminal date, were favorably treated. A firm with equipment which came to the end of its useful life during the emergency period could not, except at a penalty, replace this equipment, whereas the firm which had no equipment wearing out was not hurt. The scheme was suspended for assets acquired after December 31, 1952, apparently because inflationary pressures had slackened.

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Penalty schemes

Some economists have believed that more stability of investment could be secured if the tax system attempted to tie depreciation allowances to actual investment. Unless a corporation used its accumulated reserves, the amount of depreciation which it could charge for its old investment would be restricted. Any stimulus provided by this scheme would come in a period of depression. In good times the amount of investment by most firms is likely to be in excess of depreciation accruals, whereas in poor times firms will tend to accumulate liquid reserves.

This penalty device, as most others, is subject to the general defect that it strikes at a symptom.[22] Why does business sometimes prefer liquidity? Chiefly because investment is unattractive, and it might happen that a penalty system would be interpreted as a threat to enterprise. Firms would fear controversy over what was an allowable investment and over their attempt to liquidate through nonreplacement. Administrative difficulties in framing relief provisions for firms with clear needs for liquid assets would arise, and if solved, loopholes might be opened which could be used for evasion by other firms. Conceivably the net effect on investment incentives would be adverse.

The scheme has, moreover, the technical fault that "most accountants and informed business executives regard depreciation allowances, not as a means of financing replacement, but as merely a method of recovering costs."[23] The question of *finance* and the question of *replacement* of physical assets are not identical.

A related scheme would put a penalty not merely on idle depreciation reserves, but on all idle business funds. The base of the corporation tax would be net profits *plus* depreciation accruals, but *minus* investment spending and dividend distribution.[24] The amount of tax could be reduced *either* by investment

22 See Harold M. Groves, *Postwar Taxation and Economic Progress* (New York, McGraw-Hill Book Co., 1946), pp. 303-06.

23 Goode, *op. cit.*, p. 173.

24 Investment would mean chiefly expenditure to replace or expand plant and equipment, and possibly "the value of the increase in inventories (excluding markups) not deemed to be 'excessive.'" The Winning Plans in the Pabst Postwar Employment Awards (n.p., 1944), Ruth P. Mack, "The Fullest

spending *or* by paying out dividends. This choice would make corporations reconsider their practices concerning retention of earnings vs. dividends. In cases where stockholder pressure is for larger dividends, the scheme would make this attractive; in the opposite situation (supposing section 102 did not interpose), larger investment and smaller dividends in order to avoid individual income tax might seem indicated.

The objections raised against the tax on idle depreciation reserves apply to this scheme.

Inventory valuation

Present exaggeration of profit and loss

The postwar years, with their combination of inflation and high taxes, brought vigorous discussion of methods of inventory valuation. When prices are rising, most firms using traditional methods will have fictitious profits because the value of their inventory will be above historical cost, no matter what replacement cost is. The tax base, and therefore taxes, will be exaggerated in such a period. *Per contra,* in a downswing losses will be exaggerated, the tax base—and taxes—will be sharply reduced.

Built-in flexibility enhanced

Some economists have felt that this situation has advantages for fiscal policy since the built-in flexibility of the corporation income tax is enhanced. The fictitious enlargement of the tax base in boom warns business to be careful and to restrain investment; the fictitious reduction in depression reduces taxes (and may bring refunds), and thereby eases the cash position.[25] On the other hand, some economists argue that

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Measure of Employment After Victory," p. 63. See also Musgrave, *Public Finance and Full Employment,* in Federal Reserve System, Postwar Economic Studies, No. 3, pp. 39-40.

[25] See Douglas H. Eldridge, "Issues Raised by Proposal to Grant Cost or Market Option with Lifo," *National Tax Journal* (March 1953), p. 65; Goode, *op. cit.,* p. 171; W. Froelich, "Income Determination and Investment," *American Economic Review* (March 1948), p. 91.

The profits position and the cash position have opposite effects. Thus high profits, because fictitious inventory gains are included, mean high taxes which tighten the cash position of a firm. The tighter cash position may serve to warn the firm that some of its profits are unreal, and this, in turn, may reduce the desire to invest.

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the taxation of inventory profits and deductibility of inventory losses are exceedingly blunt tools with which to implement a countercyclical fiscal policy. So far as general economic considerations are concerned, it would seem much wiser to adopt a concept of income which will promote intelligent decisions by business managements, labor, and government officials, and to rely on other means of achieving a balance between government revenues and expenditures adapted to the general economic situation.[26]

Opposite effect of Lifo

The substitute for historical cost in methods of inventory accounting which has been widely adopted is Lifo.[27] It serves to exclude inventory profits and losses from business income and, therefore, to reduce the tax base and taxes in inflation and, conversely, to raise them in depression. These effects are contrary to the theory of fiscal policy since they restrict the built-in flexibility of the corporation income tax. The diversity of appraisal by economists, already cited, obviously also applies here. Perhaps one may, with Richard Goode, accept Lifo as a *fait accompli*[28] for a limited area of business, supposing the inflationary pressures of recent years abate.

Tax credits

Stimulus to depression investment

The schemes for manipulating depreciation discussed in Section 3 reduce corporate tax liabilities in the short run in an effort to secure greater stability of investment over the cycle, larger aggregate investment and national income in the long run, and incidental increase of tax collections. The potential gains are so

[26] J. Keith Butters and Powell Niland, *Effects of Taxation: Inventory Accounting and Policies* (Boston, Graduate School of Business Administration, Harvard University, 1949), p. 108; also Groves, *op. cit.*, p. 153.

[27] Last in, first out, as opposed to Fifo—first in, first out.

[28] Extension to Lifo users of the option to value inventories at the lower of cost or market would, however, bring a great expansion of its use with a parallel growth of perverse countercyclical effects.

It may be noted that a considerable discussion of adoption of current-cost valuation for depreciation allowances of plant and equipment has appeared. Adoption would seriously impair the built-in flexibility of the corporation income tax. Besides the references already given, see E. Cary Brown, *Effects of Taxation on Depreciation Adjustments for Price Changes* (Boston, Graduate School of Business Administration, Harvard University, 1952).

great that the Congress might consider making a greater effort to secure them. Instead of sacrificing revenue in the short run with recovery of much of it later, Congress might take the bolder step of subsidizing investment in depression by actual payment from the Treasury of a percentage of eligible private outlays, or by a tax credit tied to such outlays. While in principle the two are similar, the latter seems less radical and discussion will be confined to it.

For purposes of fiscal policy the credit would be zero when employment was high and positive only when employment was low.[29] A merit of the scheme appears to be the immediacy of its impact; a firm which acted would secure the tax credit at once; the timing of the investment would be in direct response to the desire of the government.

What types of investment?

Should all investment be eligible? Exclusion of equipment ordinarily chargeable to current account, of second-hand items, and of inventory would be indicated by administrative considerations. The first exclusion would raise many borderline issues, but the test that only depreciable items were eligible seems feasible of application. Exclusion of second-hand items would have the defect of striking at small concerns,[30] but inclusion would open a major channel for evasion. Inventory raises special problems because of its volatility and the danger, therefore, that tax credits would aggravate speculative buying and selling.

Awkward announcement effects

A scheme of this sort also faces awkward announcement effects both at initiation and termination. If firms believe that a tax credit is in prospect, they will retard investment and thus worsen the economic situation. And whenever the scheme is made effec-

[29] The logic of the scheme would indicate the levy of a special *tax* against investment in periods of boom, i.e., *negative* credits. To me, however, this logic seems to lead beyond what is feasible. In logic also the scheme should apply to all investment and not merely to that made by corporations, but again such extension seems impractical.

[30] Gordon Keith, "Repercussions of the Tax System on Business," *Fiscal Policies and the American Economy*, K. E. Poole, ed. (New York, Prentice-Hall, 1951), p. 354.

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tive, complaint will be heard from firms which had acted just ahead of the announcement. No remedy seems feasible, but certainly the adverse effects would be aggravated by a prolonged and public period of predecision, and lessened if this period could be short and secret. Termination problems could be eased if the original announcement of the credit specified a minimum time for its duration, and if a decision to terminate were announced well in advance of actual termination. But again the difficulties should not be concealed. In broad terms, the best plan would be to let business know that the tax credit is a depression device, subject to termination in recovery. For this reason a scale of graduated tax credits would be unsatisfactory, since it would bring uncertainty at every step in the scale. Rather would it be better to give a substantial credit—say 20 percent—when business conditions were poor, e.g., when unemployment reached x million, and to terminate it when unemployment fell to y million. Business, aware that a credit is not permanent, may be able to make provision against withdrawal.

It should, perhaps, be noticed that an attempt to solve announcement problems by a technique similar to that suggested for state-local public works—advance submission and clearance of projects—would be dangerous to the free-enterprise system. Applied to business projects, it would put a detailed and undesirable control of private investment in the hands of the government.

The tax-credit scheme appears to have much more leverage than any other. The Treasury makes an immediate and obvious sacrifice of revenue, which would be an outright loss, incurred even if no *new* investment were induced by the scheme. If, for example, eligible annual investment in plant and equipment is $15 billion and the tax credit is 20 percent, the revenue loss would be $3 billion. But the confident hope of the Treasury would be that the reduction in the cost of investment would persuade firms not only to invest idle internal funds, but also to seek external funds. Outside equity capital might be attracted by the improved prospect of net earnings and outside debt capital by the improved debt-equity ratio.

14

Taxes on Expenditures

> For control of consumption variation in rates of outlay taxes is the most effective means (in the absence of a workers' income tax). . . . The essence of success in an anticyclical policy is speed of reaction to the measures taken. . . . Consequently, since consumption can be influenced more quickly than investment (because the planning period is shorter), the first attack must be launched against consumption. Outlay taxes must thus be the first weapons to be brought forward.—URSULA K. HICKS.[1]

1. INTRODUCTION

For many decades federal taxation, consisting almost wholly of customs duties, and excises upon liquor and tobacco, fell relatively heavily upon consumption. With the introduction of the income tax, the trend—sometimes slow and sometimes fast—has been away from consumption taxation. A general federal sales tax has never been levied, although often considered by Congress. Economic opinion has been opposed to such a levy, mostly on grounds of equity, and, in recent years, use by the state governments of sales taxes has put a practical obstacle in the way of federal use. In 1942 the federal Treasury did propose a so-called spendings tax to be assessed against individuals and measured by the amount of individual spending over a period of time. The aim was to penalize wartime spending for consumption and give incentives to saving. Perhaps because of its newness, or perhaps because of serious administrative problems, Congress dismissed the spendings tax after cursory consideration. It did, however,

[1] Ursula K. Hicks, *Public Finance* (London, Nisbet & Co., 1947), p. 327.

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enlarge the system of federal excises, and in the postwar period no important reductions were made until 1954.[2]

Impact of excises on consumer spending

In fiscal 1953 excises were levied on sixty commodities and services, and the revenue from them was $9,943 million. This amount, if spread evenly over total consumer spending, would be at the rate of 4.4 percent. In fact only about one quarter of total consumer spending is subject to federal excises, with coverage of durables much greater than that of nondurables and services. At present the percentages of expenditures subject to federal excises are approximately as follows: durables, 62 percent; nondurables, 19 percent; services, 13 percent. The bulk (75 percent) of the total collections come from the limited list of items given below:

Table 9. YIELD OF SELECTED FEDERAL EXCISES IN FISCAL 1953

	(in millions)
Liquor, wine, beer	$2,781
Tobacco	1,655
Gasoline	891
Transportation of persons and property	708
International telegraph, cable and radio	418
Admissions	360
Local telephone	358
Jewelry	235
	$7,406

Except for furs, jewelry, and toilet preparations, which are collected at the retail level, collections of commodity excises are made from manufacturers.

The three quarters of consumer spending *not* reached by federal excises includes foodstuffs, most services, some consumer durables and semidurables, such as clothing and shoes, furniture, dishes, etc. It includes also consumer spending on second-hand goods, of which the largest single amount is for used cars.

Generalizations concerning the intentions of Congress in select-

[2] In 1949-1950 a drive to repeal or reduce many of the wartime excises would have been successful had not war broken out in Korea.

ing commodities for excises are difficult to make, especially by use of the ill-defined terms, luxuries and necessities. One may perhaps say loosely that the aim has been to avoid excises on necessities, narrowly defined, and to impose excises on semiluxuries. The wartime expansion of excises on durables had as special motivations to reduce the scope of rationing, to support the rationing mechanism and the legal price ceilings, and, in a limited degree, to absorb purchasing power. Retention of these excises postwar is to be explained by the simple fact of financial need.

2. BUILT-IN FLEXIBILITY

Elasticity of yield of present excises

For federal excises as a whole this is not great because demand for the commodities which yield over half the receipts—liquor, tobacco products, gasoline—is income-inelastic, as well as price-inelastic. Not only will price changes up or down bring a less than proportionate change in sales, but so also will changes in disposable income of individuals. A change of 1 percent in disposable incomes would probably not bring more than a change of ½ of 1 percent in revenues from these commodities.[3] The elasticity of the yield of excises on another group of items—lubricating oil, tires and tubes, general admissions, refrigerators and air-conditioners, toilet preparations, transportation of persons—is somewhat greater being probably more or less proportionate. This group now is responsible for about 18 percent of collections. The revenue response of the remaining items—such durables as passenger cars, trucks, radios, automobile parts and accessories, as well as such "luxury" items as furs, jewelry, luggage, cigars, etc.—is quite substantial. This group provides about 16 percent of the current collections.

For the excises as a whole, then, elasticity of yield might be .75 and the built-in flexibility .03. A fall in disposable income of 10 percent—say from $235 billion to $211.5 billion—would bring

[3] To the items listed above one should probably add, as in the same class, local telephone service, electrical energy, matches. It should be noticed, however, that the inelasticity, both in terms of income and price, of the demand for cigarettes and gasoline is greater than that for distilled spirits and beer.

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a fall in excise revenues of 7.5 percent—say from $9.9 billion to $9.2 billion.

Revision of the excises solely for the purpose of increasing built-in flexibility and elasticity, while keeping the total of collections the same, is politically not promising. The reductions made in 1954 affected excises on communications, admissions, some retailers and manufacturers sales, altogether lowering tax receipts by about $1 billion. The excises on communications and manufacturers sales tend to be pyramided through successive mark-ups and to bring price increases in the final goods purchased by the consumer quite out of proportion to the original excises. This was the justification for their reduction. The other reductions were given because the excises were alleged to have had a severe impact on the profits of retail outlets. Yet it seems clear that the retail excises are flexible to changes in economic conditions; their repeal brings a loss of built-in flexibility.

3. *COUNTERCYCLICAL CHANGES IN RATES*

In depression

Price-inelastic items

Consider next the effects of altering the *rates* of excises for countercyclical purposes. In depression lower rates on items which are price-inelastic would bring a fall in aggregate expenditures on the items, and, as a result, a substantial increase in disposable income for use in other directions. A hypothetical case will serve to illustrate (see Table 10). Suppose item A with an inelastic demand so that when the unit price is $20, the quantity sold is 100, and when price falls to $15, i.e., by 25 percent, the quantity sold rises only to 105, i.e., by 5 percent. Suppose further that these changes grew out of a reduction in excise from $10 to $5 per unit, i.e., by 50 percent. Obviously revenue collections will fall from $1,000 to $525, spending on the item from $2,000 to $1,575, and thereby incomes will be freed to the amount of $425 for use in other ways. Commodities of this type typically absorb a relatively larger part of the consumption spending of the lower- than of the higher-income brackets, and the effect on consumption of *other* things of cutting excise rates on them

would be appreciable. But, as has been indicated, the chief commodities of this type now subject to federal excises are liquor and tobacco. Reduction of these excises in depression would be unlikely to receive public or political approval. Reduction of

Table 10. HYPOTHETICAL VARIATION IN EXCISE RATES FOR COMMODITIES WITH ELASTIC AND INELASTIC DEMANDS

Quantity	*Unit Price*	*Unit Tax*	*Tax Collections*	*Aggregate Spendings*	
		Excise Rate Decrease			
		Commodity A with Inelastic Demand			
100	$20	$10	$1,000	$2,000	*Freed Income*
105	15	5	525	1,575	$425
		Commodity B with Elastic Demand			
100	20	10	1,000	2,000	*Absorbed Income*
150	15	5	750	2,250	250
		Excise Rate Increase			
		Commodity A with Inelastic Demand			
100	20	10	1,000	2,000	*Absorbed Income*
95	30	20	1,900	2,850	850
		Commodity B with Elastic Demand			
100	20	10	1,000	2,000	*Freed Income*
30	30	20	600	900	1,100

excises on other items with an inelastic demand—gasoline, local telephone service, electrical energy, matches—would, however, not encounter this obstacle.

Price-elastic items

Lower excises on items with a price-elastic demand—durables *plus* a limited list of "luxuries"—would bring a small fall in revenues, an increase in aggregate expenditures on them, and, therefore, a reduction in disposable incomes to be used in other directions. Suppose item B with an elastic demand so that when

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the unit price is $20, the quantity sold is 100, and when price falls to $15, i.e., by 25 percent, the quantity sold rises to 150, i.e., by 50 percent. Suppose further that these changes grew out of an excise cut from $10 to $5 per unit, i.e., by 50 percent. Revenue collections would drop from $1,000 to $750. Spending on the item would grow from $2,000 to $2,250, and thereby more income than before would be absorbed. Excise reduction on such items—durables—while giving a stimulus to their production, would lead to a net absorption of disposable income from use in other directions. A direct general stimulus to consumption would *not* be provided as it would by reduction of excises on price-inelastic commodities.

The excise rate changes indicated by fiscal policy would be, therefore, reduction of those on commodities of wide consumption and of price-inelastic demand. Such a reduction would bring an increase in disposable incomes. Insofar as these commodities form a large proportion of the consumption of low-income groups, the released income is likely to be spent rather than saved (although this spending will flow least to the commodities on which excises were reduced). The scope for federal excise reduction of this type is, however, limited because many of the items which meet the tests of price-inelasticity and wide consumption—notably liquor and tobacco—are, for institutional reasons, unsuitable candidates for depression tax cuts.

In boom

In a period of boom and inflation higher rates of excises on durables, demand for which is price-elastic, will markedly reduce collections and the aggregate spendings on them. Incomes will, therefore, be freed for use elsewhere. Conversely, higher rates on commodities with inelastic demand will raise collections and aggregate spending on them, and, therefore absorb incomes (see Table 10).

In short, fiscal policy would indicate that excise rates be raised on items of inelastic demand and wide consumption. Such a move would be regressive—indeed, the more regressive the excises the more effective would be their increase. When employment is high and inflationary pressures are spreading because the rate of consumption spending exceeds the rate at which goods are being supplied, a check can only be supplied by heavier taxes on low-

and middle-income groups which originate most of the consumption spending. The high-income groups in the aggregate are not responsible for much consumption, and no substantial reduction in total national spending can be secured by taxing their consumption.[4]

Equity considerations

The above policy, by itself, conflicts with considerations of long-run equity, but in defense it can be argued that the policy is not designed to be long run. Inflation is inequitable for the ordinary citizen both in the short and in the long run. Taking away from him, in a short-run situation of inflation, money that would otherwise have gone to higher prices is not really to impose a tax burden. Equity considerations condemning regressive taxation apply chiefly when there is economic stability at high employment, or in depression. When inflation is being fed by excessive spending for consumption, a curb on consumption which helps to achieve economic stability is not to be regarded as inequitable.[5]

4. A FEDERAL SALES TAX

While the likelihood of a federal sales tax, short of further deterioration in international affairs, seems remote, a brief appraisal of the fiscal policy issues will be offered. Professional opinion would favor a tax at the retail, rather than at the manufacturers level. The base of such a tax would be very large,

[4] The deflationary effects of higher excises is often misunderstood because their direct effect is to raise the price of the items on which they are imposed. The difference between this price increase and the ordinary one is that the latter increases factor-incomes, while the former does not. The excises *absorb* purchasing power by the process of raising prices. An increase of income tax absorbs income *before* it can be spent.

E. Cary Brown shows that "consumption taxes are more effective, dollar for dollar, in cutting back consumer outlays than are income taxes—and this conclusion holds even though everyone be assumed to have an identical marginal propensity to consume." "Consumption Taxes and Income Determination," *American Economic Review* (March 1950), p. 85. If consumers have a money illusion, i.e., if consumption expenditures are a function of disposable *money* income, the effectiveness of consumption taxes in reducing real consumption is magnified.

[5] See the arguments of A. P. Lerner and Fritz Machlup in the *Review of Economics and Statistics* (February 1948), pp. 25, 210.

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amounting to $130 billion in 1952, although this is less than total consumption spending since, for administrative reasons, a good deal of spending cannot be reached.

Curb to inflation

A retail sales tax, because it is regressive, would seem to be a strong instrument to curb inflation. It is demand-absorbing, striking directly at spending for consumption not only out of current income but also out of the proceeds of the sale of assets. Saved income is not touched. For this reason it is favorable to work incentives. Additional income, so long as it is not spent, is left with the recipient; the value of work over leisure is enhanced.

The direct antiinflationary effect of imposition, or increase, of a retail sales tax is, however, subject to an important qualification. Because of its regressiveness, demands for wage increases might follow which, in an inflationary situation, might meet with slight resistance from employers. Even if negotiation of new and more liberal wage-contracts is avoided, some 1,300,000 workers are now under contracts which contain escalator clauses moving wages up and down with changes in the Bureau of Labor Statistics Consumer Price Index. It is reckoned that a 5-percent general retail sales tax would increase the index by 3.5 percent; one of 10 percent, by 7 percent. Thus the tax would serve to give a cost-push. Moreover, an increase in the prices of products purchased by farmers would bring an increase in the farm parity index in addition to the increases occasioned directly by the sales tax. Increases in farm prices might lead to new wage demands, and so a spiral might proceed.

Per-capita credit

These considerations would make it essential to exclude by law from the Bureau of Labor Statistics and farm-parity indexes any price increases resulting from a federal sales tax. Politically such a step would encounter resistance. To overcome this resistance, and also the charge of inequity, the most effective device might be to provide a flat per-capita credit against income tax.[6]

[6] Other remedies have been proposed, most frequently that expenditures for food and medicine be excluded from the tax. This would reduce the yield by one third and it would raise difficult problems of administration.

The amount of the tax credit is a matter of judgment, but any sum less than $50 per person would not seem acceptable. A genuine problem would grow out of the large number of families —10 million—not now filing income tax returns. In order to secure a refund of the credit these people would have to file the short form.

The credit itself would provide a very strong tool for fiscal policy. Its increase in depression and reduction in boom would contract and expand tax collections effectively with a minimum of administrative red tape. A large credit could not only wipe out all revenue, but institute a system of family allowances.

5. *EXCISES AND INCOME TAX CONTRASTED*

The impact for fiscal policy of present excises is much less than that of the individual income tax because of a smaller base. In 1949 only $40,609 million of total consumer spending of $178,832 million—that is 22.7 percent—was subject to federal excises, the average rate being about 20 percent, whereas taxable net income was $88,442 million, subject to an average rate of 16.4 percent. Or, to put the contrast in simple terms, the revenue from the individual income tax—$14,500 million—was 70 percent larger than that from excises—$8,400 million—despite the larger *potential* base provided by consumption.

Superior anti-inflationary effects of excises

As a curb to inflation, increase in income tax rates decreases disposable income and strikes at spending of individuals according to their marginal propensities to consume. Increase of excises, by striking directly at spending, provides individuals with the chance to reduce or avoid the tax by increasing their saving and their liquidity preference. For related reasons, the excises may be expected to have superior incentive effects to the income tax in a period of boom. They enhance the value of work over leisure, whereas a progressive income tax is a deterrent to additional work. And it should be noticed that the fact of a personal exemption, combined with a moderately high beginning rate, creates high marginal rates.

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Superior antidepression effects of excises

In depression a decrease in excise rates provides a direct incentive to spend, and it discourages saving by lowering liquidity preference. The parallel effect of decreased rates of income tax is immediately upon disposable incomes, the increase of which may be spent or saved. This advantage of excises is, however, less clear when imposition is at the manufacturers level, as most federal excises are. The reason is that the impact of an excise at this level is somewhat concealed from the consumer, and reduction or increase will operate by default through a rise or fall in savings. The incentive effect of excise reduction in depression would, however, seem inferior to that of income tax reduction. At such a time few people will wish to substitute leisure for work. When lower income taxes increase the attractiveness of work over leisure via the substitution effect, the income effect is unlikely to pull against it, since most people are unlikely to feel rich in depression.

Faster congressional action on income tax

Generalizations concerning the relative speed of Congressional action in altering excises or income taxes are not very convincing. But if it is assumed that Congress will retain full power, action on the income tax should be more speedy. The reason is that, if increased (decreased) rates of excise are in prospect, people representing each commodity may ask to be heard, while no similar organized external group will argue over higher (lower) income taxes. If, however, Congress would set up, in advance, rates of excises thought to be appropriate to given economic conditions, or if it would delegate power to act, the advantage in speed would belong to excises. This is so because, administratively, excise changes do not require withholding tables, amendment of declarations, or year-end recomputations.

If Congress retains full power to act in its own hands, one very special and important obstacle to excise changes remains to be noticed. This may be called the short-run announcement effect. Whereas expectation of a cut in income tax might well have the desirable effect of stimulating an anticipatory increase in spending which would generate income expansion, expecta-

tion of decreased excise rates would induce people to slacken spending and thereby to aggravate the prevailing depression. The prospect of higher income tax rates might, in a boom, induce some people to increase their saving in order to be ready for their increased tax liability; but the prospect of higher excises would spur buying and dis-saving. Could these disturbances be avoided? The British avoid them (1) by keeping the tax program which is announced in the budget speech wholly secret from the public and (2) by making excise rate changes effective upon announcement. Traditional Congressional practice is wholly different, and no change can be expected.

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Conclusion

Growth vs. stability

Two major goals of economic policy are: (1) increase in the level of the national income and (2) reasonable stability in its level and, as a consequence, in the amount of unemployment. Until the great depression most economists thought that the former was of prime importance and that it could be achieved by encouragement of savings and investment; they were not greatly concerned about the latter. This attitude coincided with that of government, especially in the United States. *Local* government might at times need to take steps to provide relief for unemployed employables. But state governments, and still more the federal government, could remain aloof because unemployment had been tolerable both in amount and in duration. As has been shown, the record as a whole warranted the belief that government, especially the federal government, need not concern itself with instability of employment.

But after 1930 the situation was different both in the United States and in other Western nations. The problem of unemployment came to dominate the political scene. During the decade of the 1930's the threat of social revolution everywhere became very real, and in one great country, Germany, the actual Hitlerian revolution can plausibly be attributed to prolonged experience with severe unemployment.

In the 1930's the goal of economic growth gradually lost place. Governments, driven by events, fumbled with programs of relief and work relief; economists, forsaking the old opinion that the road to recovery from depression was through correction of structural maladjustments, advanced the new theory of fiscal policy. And employment experience during World War II seemed to confirm the new theory and to provide a period of respite

during which governments could prepare the machinery to put it into operation. In the English-speaking and Scandinavian countries national governments made an explicit acknowledgment that maintenance of a high level of employment was henceforth to be a major function.

Acceptance of the goal of economic stability does not mean that the goal of growth has been discarded, or that pursuit of the one must be at the *expense* of the other. Sometimes, indeed, a conflict appears. For example, a high rate of investment is the means by which rapid growth in national income must be achieved; yet a high rate of investment, which is followed by a low rate, brings economic instability. The conflict is resolved only if investment over time proceeds at a rate which can be *maintained.* If, through techniques of fiscal policy, this is achieved, neither stability nor growth would be sacrificed. Rather would the long-run result be to raise national income to new levels because, with stability, investment in larger volume would be induced.

Deficiencies of fiscal policy

Fiscal policy, both in theory and in application, has serious deficiencies. The theoretical deficiencies are chiefly in points of detail. Economists will generally agree to the broad principles that aggregate demand is the most important determinant of employment, that government provides a large segment of this aggregate, and that this segment can be varied so as to be inverse to variation in the remainder, i.e., the private portion. And alteration of the public segment may have both quantitative and qualitative effects. Opinions differ, however, concerning the relative effectiveness of different techniques of altering the public and the private demands. In early formulations, when attention was centered on policies appropriate to recession, the bias was toward increase in government spending to secure an increase in consumption. Today it is recognized that decrease in government revenues is an alternative or a supplement. Moreover, use of fiscal policy to curb inflation has received attention. Within the business cycle sometimes investment and sometimes consumption will be the appropriate variable to encourage or restrain.

Two major problems of theory remain: (1) How to make ac-

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curate short-run forecasts of the economic situation? (2) How to appraise the effective force of the numerous techniques of fiscal policy? Early solution of the first problem is unlikely. In such case the conclusion follows that fiscal policy action should be geared not to forecasts, but to actual situations. So long as a forecast is inaccurate, governmental action based upon it may be harmful rather than remedial. Ironically enough, the inadequacy of current forecasting brings no diminution in its volume. Rather the contrary and, at any point of time, almost any type of forecast is available to a Congressman who wishes to secure a prop for policies which he favors.

The second problem is more tractable. Academic economists will explore the issues and add to our knowledge of the force of specific measures of fiscal policy. This slow accretion should, however, be speeded up by governmental research in the Treasury, the Budget Bureau, and the Council of Economic Advisers. Such research is particularly suitable for these agencies because it requires a knowledge of technical detail seldom possessed by academic economists and because it may require examination of statistical material not available to, and not readily handled by, the individual researcher. Policy-making officials in Washington so far have shown little awareness of the need for this research, even though it would seem that quantification of the theory of fiscal policy so as to provide knowledge of the compensatory force of fiscal changes should be duties of the CEA and the Budget Bureau. If approximate answers concerning built-in flexibility and important discretionary programs could be found, the political and administrative difficulties would be less serious. An important reason why Congress is lethargic in its approach to fiscal policy has been the thin factual basis offered by the Executive branch as a support for specific steps. If, for example, Congress could be told what, in given circumstances, the effect on disposable income of a change of $100 in the per-capita exemption of the individual income tax would be, differences in opinion concerning the wisdom of such a move would be narrowed.

The political obstacles in the way of a successful fiscal policy arise because our system, shaped to allow full expression of dissent, is antithetical to quick Congressional decisions about debatable issues. This inertia is reinforced by the present vast

size of the governmental establishment. It may be that the dilatory slant of democracy is outmoded; it may even be that preservation of modern democracy rests not upon principles which matured two hundred years ago, but upon functional efficiency. But this opinion is not widespread and reorganization of Congress for the purpose of securing speed in fiscal policy is not at present a political likelihood.

Virtue of built-in flexibility

Fortunately fiscal policy has one important instrument by which Congressional inertia can be by-passed. If Congress, at its leisure and in full compliance with established procedures, enacts revenue and expenditure measures which are automatically countercyclical, its inertia in time of economic stress may even be a virtue. Quite by accident, the built-in flexibility of the present fiscal system is appreciable, and, as has been indicated earlier (Chapter 8), this could readily be strengthened. In summary, built-in flexibility would be greater:

1. If the per-capita exemption of the individual income tax were higher, and progression steeper.
2. If the corporation income tax allowed (a) longer carry-backs than two years, (b) preinvestment accumulation of tax-free reserves to be released in depression, (c) tax credits for investment undertaken when employment is low.
3. If federal excises upon durable consumer goods were given greater emphasis.
4. If the rate of the payroll tax for unemployment insurance were set at a level figure for a period of 7-10 years.
5. If the federal grants for public assistance were converted into block grants which varied countercyclically in relation to a "national minimum" and a "standard fiscal effort."
6. If federal grants for public construction were enlarged to provide (a) planning grants and (b) grants for state-local projects of every type when these had been cleared in advance. The construction grants would be variable both in total amount and in percentage so as to be high when the level of private construction was low, and low when it was high.

Different types of built-in flexibility

The instances given above may appear to equate the meaning of built-in flexibility to that of automatic stabilizers. Yet exam-

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ination will reveal that automatic formulas for *tax rate* changes are not included. In order to appreciate the reasons for this exclusion, some refinement of the meaning of built-in flexibility is necessary.

1. The simplest and least sophisticated instance of built-in flexibility is present when taxes have important and meritorious characteristics which, incidentally and as a by-product, create built-in flexibility. For the individual income tax, such features as current payment and some scale of progression are of this nature. Neither their introduction nor their retention can be credited to a desire for built-in flexibility. An important feature of this type of built-in flexibility is that its operation is not related to any separate and external formula; instead it is all in one piece.
2. Another type is illustrated by unemployment compensation and agricultural price supports. Here a separate formula is provided which governs the expenditure to be made. Congress sets up formulas, satisfactory to it, which govern the ebb and flow of payments to designated segments of the population.
3. Now it should be noticed that automatic formula schemes to govern changes in *tax rates* can be devised which would be very powerful in their effect on incomes. In essence these schemes would (a) set up a general formula to signal the presence of recession and boom, (b) provide that the signal automatically would be the authority for a change in tax provisions. For example, a rise of so many points in a price index in a period of time might bring into operation a higher scale of rates for income tax, or possibly a lower per-capita exemption. Conversely, an increase in employment might be the signal for action of the opposite sort. In ways such as these the amount of taxable income, and of tax collections, could be increased or decreased automatically because of an over-all change in economic conditions as reflected in some index of prices or employment.

Demerits of automatic tax changes

What significant differences exist between (2) and (3)? Most obviously the formula of (2) provides authority for changes in expenditure, that of (3) for changes in taxation. While Congress has been jealous of its right to vote appropriations, it has been much more jealous of its right to vote changes in the tax laws. Another difference is that the expenditure under the formula of (2) is specifically defined as to purpose, whereas the tax change is general and across the board. Congress has been willing to abdicate much of its discretion with respect to expenditure for

agricultural price supports or for covered unemployment. In so doing it has defined the terms and circumstances with fair precision, and it has made the reasonable assumption that farmers and workers who receive payments will be in need. But Congress may be less willing to delegate to a formula which will alter taxes (or even expenditures) for the *general* purpose of altering the aggregate of incomes or employment. It may feel that the lack of specific relationship will have incongruous results for particular persons. For example, a decrease in the per-capita exemption in response to a rise in the price level, while "right" in its general effect, would bear doubly on persons with fixed incomes, since they would be hurt both by the rise in prices and the decrease in exemption. Conversely, an increase in the per-capita exemption in response to a decrease in employment would increase incomes (after tax) of taxpayers whether or not their incomes (before tax) had fallen. These differences may justify a difference in Congressional attitude. Congress may feel that it should retain full discretion to make tax increases or decreases when these rest upon *over-all* considerations of fiscal policy. Extension of built-in flexibility of this type may be rejected.

Limited role for built-in flexibility

The merits of built-in flexibility as a countercyclical device would, moreover, be impaired if it were made very powerful. The reason is that built-in flexibility is inflexible and even arbitrary in its effects. Since every boom and slump is different in detail, an automatic program, even when adequate in *level,* might be less appropriate than a discretionary program which was tailored to fit the case. There is, besides, the difficulty of determining the force and sensitivity of a system of built-in flexibility. A strong system might be overadequate in the sense that the rise and fall of revenue collections would be too sharp in recovery and in boom. So long as built-in flexibility is modest, such dangers need not be feared.

The above argument, then, supports built-in flexibility secured *incidentally* (type 1), and also when secured by a formula which is tied to a particular type of expenditure (type 2). It should now be noticed that even the limited formula of (2) has faults. In order to be administratively feasible any automatic formula must

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be simple in design and fairly abrupt in its application. Moreover, any formula which is publicly displayed and calculated may have unfortunate announcement effects. For example, a formula which provided for federal grants-in-aid of state-local construction whenever private construction fell below a certain level would induce state-local officers to hold back whenever the figure of private construction approached the critical level. This effect seems unavoidable; only incidental built-in flexibility works imperceptibly and without announcement effects.

Discretionary programs

If, then, built-in flexibility is to be given a limited role in economic stabilization, planned discretionary programs will remain important. Here Congress can choose to keep full discretion in its hands, or it can delegate authority in small or large part to the Executive. Appraisal of these alternatives raises once again the political question of the inertia of Congress. A vast number of "solutions" can be offered, ranging from modest proposals to expedite Congressional procedures in certain circumstances to extreme proposals which would place great power with the Executive. The former probably cannot be made effective by *legislation*. A legislative attempt to delimit and proscribe all delaying techniques now tolerated would surely fail; a more innocuous legislative effort would be full of holes.[1] The conclusion follows that improvement in procedure must come by way of informal Congressional agreement, even though this may be impaired by lack of party discipline, by a recalcitrant chairman of an important committee, or by any other of the delays which *may* arise in the operation of our system of government.

The other type of proposal surmounts Congressional inertia by placing new power to act in the hands of the Executive. Can Congress be persuaded to make this shift, or will it, in the future as in the past, jealously retain its fiscal powers? The right of Congress to determine the details of tax legislation is deeply rooted in our history. In order to be secure against arbitrary levies by an irresponsible Executive, citizens demanded that taxes

[1] Organization of the Executive branch of the federal government for fiscal policy depends on presidential leadership and wisdom, rather than on new legislation.

be voted by their elected representatives. Today the Executive is not an irresponsible ruler, but an elected officer who can be removed without revolution. Is it necessary, then, to preserve intact the old fiscal safeguards? Cannot the modern Executive be trusted with a larger fiscal authority?

A few decades ago an affirmative argument was more convincing than it is now. Doubts have obtruded because of the rise of a new type of government of which a chief characteristic is strong executive power more firmly and skillfully protected than was the case in earlier centuries. The rise took place in nations where democratic government had weak roots. But this does not alter the fact that strong techniques have been invented in recent years which are antidemocratic. Whereas a few decades ago few would have questioned that the wave of the future was democracy, currently this belief is less sure. Democracy has an effective rival. Its friends may, therefore, be unwilling to install fiscal methods which, even if economically superior for fiscal policy, may erode democratic liberties.

The defects of our government in operating fiscal policy should not be exaggerated. Some delay and fumbling are, indeed, fairly to be associated with modern democracy. But so long as human governmental decisions remain fallible, this ineptness serves to protect society against overcommitment to error. If the Executive branch of the federal government will stand ready at all times to present to the Congress an integrated and effective fiscal policy, Congress can be trusted to put it into operation without dangerous delay.

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